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# The Effect of Corruption Distance on FDI Flows to Latin America

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PhD

The University of Edinburgh

2014

## **Declaration**

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- (a) This thesis has been composed by the author
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- (d) Preliminary results of this research were presented at international conferences and workshops as per attached list of Refereed Conference Papers:

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## **Abstract**

The aim of this research is to understand how corruption affects the attraction of Foreign Direct Investment (FDI). Studies of corruption and its relationship with FDI have yielded mixed results; some have found that corruption deters FDI others have found no relation between the two factors, while others have found a positive one. In order to further the knowledge of how corruption affects FDI this study argues that it is not only the level of corruption what might affect FDI but also the distance between host and home countries. This study presents two sections, the first one concentrates on a macroeconomic level analysis of corruption and how it affects FDI to Latin America. The second section analyses how corruption affects the decision-making process of allocating FDI to a highly corrupt host country at the firm-level. After controlling for institutional and transaction cost variables, results show that corruption distance has an asymmetrical impact. Host countries enjoying “positive” corruption distance compared with home countries as sources of FDI experience no significant increases or reductions in levels of inward FDI. However, “negative” corruption distance suffered by host countries is associated with significantly lower levels of inward FDI. Conversely, firms from home countries with high corruption are undeterred by high corruption in host countries. This study also analysed how corruption affected foreign investors at the firm level. To do so, this study researched the decision making process of allocating FDI into a highly corrupt host country. The results of the analysis show that corruption amongst bureaucrats, judges, and members of the government elite do not seem to have an impact on the decision making process of allocating FDI in the country because foreign investors are aware of the problem. However, firms from more corrupt countries seem to have an advantage when operating in a highly corrupt foreign location because they may possess knowledge of how to cope with the arbitrariness dimension of corruption. High corruption levels in the host country seem to have an effect on the entry mode utilised by firms from countries with lower levels of corruption. Based on the results presented on this study, MNEs from less corrupt countries might opt to enter a highly

corrupt host country via wholly owned subsidiaries (WOS) rather than joint ventures (JVs). This might be explained by the fact that these investors prefer to have more control over their firms' operations in a highly corrupt country. Also, these managers need to protect their image and not to be associated with local partners that are perceived as corrupt. Finally, even though this study found evidence that all firms operating in Guatemala might participate in corrupt deals, those headquartered in highly corrupt countries are more willing to do so. This claim is based on the fact that firms from less corrupt countries might face stronger pressures from their headquarters to not engage in corrupt deals, whereas firms from more corrupt countries might not encounter such pressures.

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## List of Abbreviations

CPI	Corruption Perception Index
ECLAC	Economic Commission for Latin America and the Caribbean
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
HDI	Human Development Index
IB	International Business
IMF	International Monetary Fund
JV	Joint Venture
MNE	Multinational Enterprise
OECD	Organisation for Economic Cooperation and Development
OLI	Ownership Locational Internalisation paradigm
OLS	Ordinary Least Squares
TCT	Transaction Cost Theory
TI	Transparency International
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNP	United Nations Development Programme
VIF	Variance Inflation Factor
WOS	Wholly Owned Subsidiaries

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## **CHAPTER ONE: INTRODUCTION**

The aim of this study is to analyse how corruption affects the attraction of foreign direct investment (FDI) to a highly corrupt host location. Even though the study of FDI has been a popular topic in the international business (IB) discipline (Buckley, 2002), the recent surge in FDI flows to developing countries, generally experiencing high levels of corruption (Transparency International, 2011), requires new attention (Habib & Zurawicki, 2002) because this phenomenon generates an empirical anomaly that seems to contest existing theoretical arguments regarding this issue (Cuervo-Cazurra, 2008).

Corruption is considered to at least damage operations of multinational enterprises (MNEs) when conducting businesses abroad (Rodriguez, et al., 2005). However, countries considered as highly corrupt still receive large amounts of FDI. Therefore, it can be inferred that high levels of corruption do not totally deter FDI to these locations. Hence, developing knowledge of how to cope with corruption can be considered as a basic activity in IB that can offer an advantage to individual firms (Rodriguez, et al., 2005).

Despite its popularity, the study of FDI is a complicated endeavour because of the number of variables that intervene. Amongst the variables used to explain FDI there are some that are measurable and accessible, such as economic indicators. On the other hand, variables such as the quality of the human resources, government participation, and the competitive environment are much less obtainable. Among the most difficult variables to quantify is the level of corruption (Cuervo-Cazurra, 2008). However, recently organisations like Transparency International have made available a measurement of corruption in the host country that although not perfect has allowed scholars to study the effects of corruption on MNEs (Judge, et al., 2011).

Understanding how corruption affects FDI is important because corruption reduces efficiency and raises costs (Mauro, 1995). Corruption also introduces distortions by affording some MNEs special access to profitable activities. Moreover, when analysing how corruption affects FDI by taking into account only the corruption level of the host country is not enough. Instead, the difference in the corruption levels of home and host countries should be taken into account since some foreign investors might not have experience in coping with corruption abroad. Furthermore, analysing how corruption affects foreign investors after the decision of investing is also important since the majority of FDI flows are part of reinvested profits.

### **1.1 Background of Research**

Corruption is usually defined narrowly as the abuse of *public* office for personal gain (Roy & Oliver, 2009). This definition is reflected in reported measures of the perceptions of national corruption levels (Transparency International, 2010). Such public corruption may have a corrosive effect on the integrity of a nation's entire system (Pope, 2000; Voyer & Beamish, 2004): it may reduce operational efficiency, distort public policy, slow the dissemination of information, negatively impact upon income distribution, and increase the poverty of an entire nation (Chen, et al., 2010; Gupta, et al., 2002). In international business (IB) studies, corruption gained prominence as firms from developed countries engaged in operations in emerging and transition economies (Habib & Zurawicki, 2001; Rodriguez, et al., 2006). Corruption was considered to deter foreign direct investment (FDI) because it may create additional uncertainty and costs of operating in a foreign country, acting as a tax on businesses (Cuervo-Cazurra, 2006; Gastanga, et al., 1998; Mauro, 1995; Zhao, et al., 2004).

However, a contrary view saw corruption as a necessary evil, a lubricant for transactions (Meon & Weill, 2010) particularly when 'institutional voids' are prevalent in developing markets (Khanna & Palepu, 2010). In the words of Cuervo-



Cazurra (2008, p. 13), corruption can be “sand or grease.” The recent surge in FDI flows into and from developing countries (often with high levels of corruption), each accounting for 50 per cent of total inflows and outflows in 2010 (United Nations, 2011), calls for a reconsideration of corruption in the IB literature.

Firms may prefer a familiar environment (Davidson, 1980) and the costs associated with corruption may vary depending on the country of origin of the foreign investors (Cuervo-Cazurra, 2006). Firms from countries with low corruption levels may not be used to dealing with this phenomenon at home (Pajunen, 2008), and hence they are likely to be deterred by levels of corruption as well as by its unfamiliarity (Driffield, et al., 2013). On the other hand, firms used to operating in highly corrupt environments at home may not be as sensitive to high corruption levels abroad. Furthermore, it has been explained that the relative *differences* between corruption levels in home and host countries may influence FDI (Habib & Zurawicki, 2002). However, current literature has not explored whether such an influence may be asymmetrical according to whether “corruption distance” is positive or negative. Therefore, this study attempts to close this theoretical gap by analysing if the corruption distance between a highly corrupt host country and a home country with either higher or lower corruption levels than the host country has a different effect to the FDI received by such location.

However, analysing how corruption affects FDI at a macroeconomic level does not fully explain how corruption affects the decision-making process of FDI allocation and further operations in a highly corrupt foreign location. For this reason, a firm-level analysis based on the levels of corruption of the home and host countries is needed to understand how not only corruption but also its different dimensions affect the process of allocating FDI to a highly corrupt foreign location.

## 1.2 Context of Research: Why Latin America?

Since the 1990s Latin America has seen a surge in FDI inflows. After several decades of almost non-existing foreign investment in the region due to strict regulations, the region experienced market-oriented reforms in order to attract more investment to the region (Trevino, et al., 2004). The deregulation Latin America experienced during the 1990s attracted important flows of FDI to the region. According to the Economic Commission for Latin America and the Caribbean (ECLAC) (2010), FDI flows to Latin America in 2009 reached US\$77.675 billion, which makes the region one of the most important recipients of FDI in the world (ECLAC, 2010).

Latin America is also a suitable region for the study of how corruption affects the attraction of FDI due to its high corruption levels. Corruption in Latin America has been defined as one of the most important threats to the region (Selingson, 2006). Also, Weyland (1998) argues that countries in the region are threatened by a staggering growth in corruption that has arisen since the dictators of the past left power. Moreover, since corruption is deeply rooted in the institutional environment of a nation, Latin America provides an ideal location to study its effects on FDI since the region's institutional environment is fairly homogeneous.

Finally, in order to conduct an in-depth firm-level analysis a Latin American country was chosen. Guatemala was identified as a suitable country for this analysis since it is considered to be highly corrupt and because of its rising influx of foreign investment (Banguat, 2012). These two circumstances offer incentives to local officials to make corrupt deals for their personal gain (Rose-Ackerman, 2008). Lastly, Guatemala offers adequate grounds to investigate how corruption affects FDI and subsequent operations in a highly corrupt country since MNEs from all parts of the world conduct operations in that location.

### **1.3 Research Questions**

This thesis was motivated due to the need to have a better understanding of how corruption affects the attraction of FDI. Therefore, the central point of this study is to understand whether or not high levels of corruption in the host country have similar effects on foreign investors based on such investors' corruption levels at home. In order to research this issue the two main research questions are:

- a) How does corruption distance between home and host country affect the attraction of FDI to emerging markets?
- b) Why are some foreign firms less negatively affected than others by high levels of host country corruption when investing abroad?

### **1.4 Research Process**

This research was conducted in two sections: a macroeconomic level to analyse how corruption and corruption distance affect FDI flows to Latin America; and a firm-level analysis conducted to examine how corruption affects the decision-making process of allocating FDI and subsequent operations in a highly corrupt host country. The rationale behind the inclusion of a macroeconomic and firm-level analysis is to compensate for the shortcomings inherent to each process individually.

The second chapter of this thesis provides an overall overview of existing literature on the determinants of FDI, corruption, and how corruption affects the attraction of FDI to highly corrupt foreign locations. The first chapter also provides a theoretical framework to analyse the two research questions of a) How does corruption distance between home and host country affect the attraction of FDI to emerging markets? And b) Why are some foreign firms less negatively affected than others by high levels of host country corruption when investing abroad?

After a description of relevant literature on corruption and its effects on FDI, the third chapter provides a description of FDI flows, its determinants, and corruption in Latin America. The chapter also offers an explanation for studying how corruption affects the attraction of FDI to Latin America. The second section of the second chapter presents an overview of FDI flows and its determinants as well as an overview of the issue of corruption in Guatemala to this issue at the firm-level.

The fourth chapter presents the methodology that was followed by this study to analyse how corruption affects the attraction of FDI to a highly corrupt host location. In order to answer the two research questions this study draws on two different approaches: macroeconomic and a firm level. The first section of this chapter uses a quantitative approach to study whether or not the distance and corruption's sign between the corruption levels of two sets of foreign investors (investors with either higher or lower corruption levels than the host location) have an effect when investing in a highly corrupt area. The second utilises a mixed method approach to examine how corruption affects the attraction of FDI and further operations at a highly corrupt host country location.

In chapter five the results of the study are presented. The first section of the chapter deals with the question: a) How does corruption distance between home and host country affect the attraction of FDI to emerging markets? To answer this question this section studied FDI flows and the corruption distance of 12 Latin American countries from the years of 2006 to 2009. The results were obtained by analysing panel data with the aid of a random effects model. On the other hand, to answer the question b) Why are some foreign firms less negatively affected than others by high levels of host country corruption when investing abroad? A firm-level analysis was utilised. The results were obtained from a mixed methodology that used semi-structured interviews and questionnaires administered to managers responsible for allocating FDI to Guatemala.

In chapter six the answers to the two research questions are assessed. Firstly, this study argues that corruption distance has a negative effect on FDI when the home countries have a lower level of corruption than highly corrupt host countries. On the other hand, when the home country has higher levels of corruption than a highly corrupt host country, corruption distance does not have a significant effect. These results can be explained because firms located in highly corrupt home countries might have developed knowledge of how to cope with corruption abroad, whereas their counterparts based in less corrupt countries might not. The second section of this chapter presents that firms from countries with high levels of corruption have developed knowledge not only to cope with overall corruption abroad but also with its different dimensions.

Finally, chapter seven presents a conclusion for this research. In the conclusions answers to the two research questions are provided. Firstly, to answer the question of a) How does corruption distance between home and host country affect the attraction of FDI to emerging markets? This study argues that it is not only the corruption levels of the host country what affects FDI. Instead, the interaction between corruption levels of both the home and host countries is what might deter FDI to highly corrupt foreign locations. However, this study also argues that corruption distance deters FDI only when the home country has lower levels of corruption than a highly corrupt host country. On the other hand, firms located in highly corrupt home countries are not affected by high levels of corruption abroad.

The second section of the conclusions, offers an answer to the second research question b) Why are some foreign firms less negatively affected than others by high levels of host country corruption when investing abroad? The answer to this question is that firms located in highly corrupt home countries are less affected by high levels of corruption abroad because they have developed knowledge of how to cope with corruption and its different dimensions abroad. Also, these firms might not face strong pressures to not engage in corruption abroad. On the contrary, firms based in

home countries with lower corruption levels than a highly corrupt host nation might not have knowledge of how to deal with corruption abroad and/or might face strong pressures from headquarters to not engage in corruption in their foreign operations.

## **CHAPTER TWO: LITERATURE ON DETERMINANTS OF FDI, CORRUPTION, AND CORRUPTION AND ITS EFFECT ON FDI**

### **2.1 Introduction**

This chapter provides a general overview of the relevant literature on the determinants of FDI, corruption, and how corruption affects the attraction of FDI. This chapter seeks to provide answers to the following questions: a) How does corruption distance between home and host country affect the attraction of FDI to emerging markets? and (b) Why are some foreign firms less negatively affected than others by high levels of host country corruption when investing abroad?

In order to answer the questions, this chapter reviews previous research on corruption, its causes, and consequences. Secondly, this chapter provides a theoretical analysis of the definition of FDI and its determinants. This chapter also analyses how corruption affects the attraction of FDI depending on the levels of corruption of the home country as compared to the host country. Finally, two hypotheses are proposed to provide an answer to the two research questions.

### **2.2 Corruption**

Corruption is usually defined narrowly as the abuse of public office for personal gain (Roy & Oliver, 2009). This definition is reflected in reported measures of the perceptions of national corruption levels (Transparency International, 2011). Such public corruption may have a corrosive effect on the integrity of a nation's entire system (Voyer & Beamish, 2004): it may reduce operational efficiency, distort public policy, slow the dissemination of information, negatively impact upon income distribution, and increase the poverty of an entire nation (Chen, et al., 2010). In the international business (IB) discipline, the study of corruption only recently gained prominence as firms from developed countries engaged in operations in emerging and transition economies (Rodriguez, et al., 2006). However, despite the popularity of the subject, the issue of how corruption affects the attraction of foreign direct

investment (FDI) to a highly corrupt location is still not fully evaluated in the extant literature.

Multinational enterprises (MNEs) may use care when choosing host countries for their foreign subsidiaries because of their concern for the additional uncertainty and operational costs associated with corruption (Kwok & Tadesse, 2006). Corruption has, consequently, been considered as deterrence to FDI (Judge, et al., 2011). A contrary view, however, does exist and has seen corruption as a necessary evil, a lubricant for transactions (Meon & Weill, 2010) particularly when “institutional voids” are prevalent in developing economies (Khanna & Palepu, 2010). The “grease the wheels” hypothesis, for example, asserts that corruption may improve efficiency by alleviating the distortions caused by ill-functioning institutions and inefficient bureaucracy (Huntington, 1968).

With more MNEs investing in developing countries (often with high levels of corruption) and with more MNEs from developing countries trading with each other, institutional differences must be acknowledged when analysing interactions between these groups (Peng, et al., 2009). Moreover, due to the recent surge in FDI flows into and from developing countries, each accounting for 50 per cent of total inflows and 30 per cent outflows in 2010 (United Nations, 2011), calls for a reconsideration of corruption in the IB literature.

Corruption varies widely across different locations in its scope in an economy as well as in the level of uncertainty it creates (Uhlenbruck, et al., 2006). Also, not all MNEs perceive and respond to corruption in the same manner. In that sense, the degree of uncertainty and the costs associated with corruption may vary depending on the country of origin of the foreign investors (Cuervo-Cazurra, 2006). For this reason, recent studies have concluded that MNEs located in countries with low levels of corruption would avoid investing in highly corrupt countries (Habib & Zurawicki, 2001). With little knowledge and skills of dealing with this phenomenon at home



(Pajunen, 2008), they are more likely to be deterred by high levels of corruption as well as their unfamiliarity with it abroad (Driffield, et al., 2013). On the other hand, firms which originated in highly corrupt environments may not be as sensitive to high corruption levels abroad; they may be attracted by the environment and even take advantage of corrupt activities (Suchman, 1995; Cuervo-Cazurra, 2006).

### **2.2.1 Determinants of Corruption**

Corruption can be found in all economies but in different degrees. However, for corruption to flourish certain conditions need to be present. Early studies analysing corruption assumed that firms were relegated to just react to their environment (Judge, et al., 2011). Nowadays, however, scholars have acknowledged that for corruption to exist both public servants and firms play important roles (Kwok & Tadesse, 2006).

Therefore, for corruption to exist there needs to be at least two parties benefitting from it. Firstly, the principal, or the firm, must have a motive to engage in a corrupt deal. Secondly, this agent should have enough information regarding how to participate in corrupt deals to maximise their rents and minimise the possible consequences (Svensson, 2005).

On the other hand, the agent, public official, has to have information regarding three elements. Firstly a public official has to have discretionary power. Roughly defined, discretionary powers include the authority to devise and administer regulations. Secondly, this power must be associated with possible economic rents. Thirdly, the probability of being caught and punished for the illicit acts must be low (Myint, 2000). In other words, corruption exists when higher rents are associated with discretionary powers and the possibility of being penalised is low.

### 2.3 Transaction Cost Theory

The transaction cost approach to the theory of the firm was created by Ronald Coase in 1937. In his work, Coase identified the existence of costs of conducting transactions. This line of thinking marked a departure from neoclassical economics that asserted that transactions occurred within efficient markets on which transaction costs were assumed to be non-existent (North, 1990). Building on Coasean thinking, Williamson intersected the theory's economic roots with law and organisation by posturing "the problem of economic organisation as a problem of contracting" (Williamson, 1985, p. 20). The transaction, which "occurs when a good or service is transferred across a technologically separable interface" (Williamson, 1985, p. 1), was then utilised as TCT's basic unit of analysis. Therefore, the organization of economic activity is thus to be understood in transaction cost terms (Scott, 1995). In this sense, TCT is concerned with the costs of integrating of operation within the firm as compared with the costs of using an external market to act for the firm in an overseas market (Williamson, 1985).

In this study, transaction cost analysis will be used to analyse how high corruption of a host country affects FDI allocation in such location. This analysis will analyse transaction costs incurred by foreign investors based on the corruption level of the home country compared to that of the host country.

#### 2.3.1 Causes of Transaction Costs

The TCT outlines the main sources of transaction costs as an array of particular risks and the attempts of MNEs to reduce them. The risks outlined in the TCT are: bounded rationality, asset specificity, uncertainty, and opportunism (Williamson, 1996).

### **2.3.2 Bounded Rationality**

Bounded rationality argues that the behaviour of economic actors involved in transactions is intendedly rational but only limitedly so (Simon, 1961, p. 24). According to Miles, et al., (1978), human actors have limited capacity to process information, cope with complexity, and make optimal choices because of the limits of the human mind and the incompleteness of available information. Therefore, bounded rationality has an effect on the ability of economic actors to make rational decisions especially when asset specificity is encompassed.

Bounded rationality is believed to increase transaction costs if information asymmetry is present (Williamson, 1975). According to North (1990), information asymmetry exists when one party has complete information that cannot be found out by the counterparty costlessly. Furthermore, information asymmetry might increase the risk of investing abroad if the investor does not have information to evaluate the costs associated to conduct business abroad. Therefore, when analysing how corruption affects FDI it is possible that foreign investors face different transaction costs due to bounded rationality. This argument is based on the information they possess about how to cope with corruption abroad.

### **2.3.3 Asset Specificity**

Asset specificity, in the TCT, means that particular assets (organisational, physical, or human) included in a transaction or set of transactions cannot be easily reorganised abroad without a significant loss of economic value (Verbeke & Kano, 2012). Furthermore, differences in the degree of asset specificity are mainly responsible for differences in transaction costs. In other words, the more specific the assets, the pricier the transaction since more safeguards should be introduced to protect the proprietor of such asset against possible economic loss. Furthermore, in the case of long-term contracts, such as in the case of FDI, greater asset specificity

not only increases the costs of contracting but also leads to interdependence between partners (Williamson, 1996).

The concept of asset specificity can be applied to physical assets that are used for a single transaction (Williamson, 1985) or technical knowledge on how to operate a business. However, Rugman and Verbeke (2002) argue that transaction costs can be reduced not only by possessing knowledge such as R&D or marketing, but from the MNE's ability to deploy their firm specific advantages to serve foreign markets.

### **2.3.4 Uncertainty**

Uncertainty in the TCT context means that organisations might encounter uncertain environments beyond their control and that might affect the costs of operations. Researchers have used a wide arrange of variables to research perceived environmental uncertainty in a foreign location. These variables include government policy, availability of infrastructure, macroeconomic features, and the variability of demand. However, one of the most important aspects creating uncertainty in a foreign location is corruption and is one of the least understood. However, uncertainty is measured differently by different foreign investors (Cuervo-Cazurra, 2006). Therefore, analysing how corruption increases uncertainty to foreign investors depending on how they perceive corruption in a host country is necessary to understand how corruption affects the attraction of FDI.

### **2.3.5 Opportunism**

The concept of opportunism is derived from human nature and denotes to the incomplete or distorted release of information, especially to the deliberate efforts to mislead (Hill, 1990). Firms are populated by human agents and those human agents are assumed to have an intrinsic tendency towards opportunism (Verbeke & Kano, 2012). Opportunism was defined by Williamson as “self-interest seeking with guile” (Williamson, 1985, p. 1545). Opportunism, moreover, manifests itself in “calculated

efforts to mislead, distort, disguise, obfuscate or otherwise confuse” (Williamson, 1985, p. 1547). This means that an opportunistic behaviour will induce individuals to seek the maximisation of their own welfare at the expense of others. Therefore, transaction costs will rise when parties try to protect themselves from risks generated by the uncertainty generated by opportunism. Opportunism is comparable to the condition of moral hazard used by Knight (1921) since it assumes that humans have an inherent propensity towards opportunism. Opportunism has a specifically harmful effect on transaction costs when asset specificity is higher (Williamson, 1985, p. 1545). This can be attributed to the fact that affected parties cannot discard a transaction without sustaining high costs from attempting to recover and reassign the assets committed (Williamson, 1993).

In this sense, opportunism is the decisive behavioural driver of market failure and the rise of hierarchy (Williamson, 1993). Moreover, problems resulting from opportunism are further complicated by the suspicion arising from low levels of trust caused by cultural differences, corruption levels being one of them. This is propelled since some practices that might not be seen as harmful in the host country might be so in the home country. As a result, MNEs will allocate FDI where laws and regulations provide safeguards to conduct operations and therefore, helping MNEs economise in transaction costs (Sara & Newhouse, 1995). Nonetheless, if the practices abroad resemble those than at home, an MNE might have an advantage even though such practices might seem harmful to other investors.

Therefore, when analysing how corruption affects the costs of operating abroad, it is necessary to separate foreign investors from home countries with low corruption from those with high corruption. This separation is needed to study how corruption affects foreign investors not only because of the corruption level of the host country but because the interaction of the home and host country corruption levels might be what increases costs of operating in a highly corrupt foreign country.

## **2.4 Expected Perceived Costs from Foreign Investors from Different Relative Home and Host Country Corruption Levels**

The transaction cost theory presents a framework to predict how firms may react to the causes of costs in terms of governance of individual transactions and their organisation structure. Therefore, when transaction costs are perceived to be too high a firm is expected to decrease the number of market-mediated transactions (Williamson, 1975). In the case of how the perception of corruption affects the allocation of FDI from companies, the perceived costs incurred by corruption of the host country will vary depending on how different firms react to corruption. Therefore, this study claims that those firms headquartered in countries with high levels of corruption will perceive the costs of operating in another highly corrupt country low. On the other hand, those firms not used to operating in highly corrupt home countries will perceive the costs associated with operating in a highly corrupt foreign environment considerably high.

### **2.4.1 Transaction Costs and Individual Transactions**

Firms have to choose to carry individual transactions in the market or to internalise them and the choice will be decided based on how efficient those options seem (Williamson, 1975). Therefore, firms will try to minimise the costs of individual transactions and for this they have to decide whether to use the market or internalise such transactions (Williamson, 1985). However, firms will use market structures when assets are not specific, transactions are not frequent, neither party has more market power than the other, and most eventualities are known. Therefore, terms can be spelled out and no adaptation or dispute is foreseen.

Nonetheless, when firms are less certain and such eventualities are more difficult to predict, the transaction cost theory argues that the preservation of relationships between transacting parties should take precedence (Williamson, 1985). Nonetheless, when analysing how corruption affects transaction costs the individual transactions approach does not fully explain the phenomenon. This is because corruption creates

an uncertain environment on which firms cannot only choose between arms-length or internalised transactions, but actually between carrying out the transaction or not.

#### **2.4.2 Combined Causes of Transaction Costs when Investing in a Highly Corrupt Host Country**

While it is important to study individual transactions and how they are affected by corruption, considering the interactions between causes of risk increase and the costs of transactions can provide a better picture of how corruption affects transaction costs. The transactional, behavioural, and environmental characteristics of a transaction are described jointly by what Williamson (1975) calls atmosphere, meaning that their separable effects, technically, are not necessarily so. Therefore, Williamson proposes to study the influence of these factors and their effects on transactions to be considered as a whole.

In the study of how corruption affects transaction costs, it can be said that an individuals bounded rationality can limit her or his knowledge relative to other parties' and therefore, this restrains his or her ability to predict outcomes (Williamson, 1985). This means that different parties might have more information regarding how corruption might affect their operations abroad. Therefore, it can be assumed that firms headquartered in countries with high levels of corruption might have more information about how to deal with corruption than those firms from home countries without such high levels of corruption.

If opportunism, that causes parties to choose an inclusive contract, is combined with bounded rationality that would lead to an incomplete contract, acute contractual difficulties occur (Williamson, 1985). Therefore, since perfect contracts do not exist, the parties are exposed to greater risks of opportunistic behaviour from their counterparts (Luo, 2007). Therefore, if firms want to protect their reputation they should remove incentives for opportunistic behaviours. However, not all firms react to opportunistic behaviour in the same manner, and this would depend on how they operate in their home country. Therefore, the opportunism created by corruption

might cause more costs to those firms not used to operating under corrupt conditions at home. On the other hand, those firms used to dealing with corruption at home might not see their costs increased due to opportunistic behaviour created by corruption in a highly corrupt host country.

Corruption increases uncertainty to foreign investors. Therefore, if opportunism is added to any relational contract arising from uncertainty, effective monitoring of such contract will need to be aided by social sanctions (Carson, et al., 2006). Nonetheless, not all foreign investors react differently to uncertainty (Cuervo-Cazurra, 2006), and this includes corruption. This means that some foreign investors might need more safeguards to protect their investments and/or might perceive the risk of doing business in a highly corrupt foreign country as too high. On the other hand, firms used to operating in a highly corrupt home country might not see high corruption abroad as a source of increase to their costs.

While opportunism and uncertainty can be found in small degree in any contracting situation, they will require small adaptations from both parties involved, and this will lead to relational governance to promote a longer-term relation (Artz & Brush, 2000). However, when high asset specificity is present, this changes. Furthermore, when foreign investors of firms with high asset specificity perceive opportunism and uncertainty derived from high corruption, this might lead to not even locate operations in such location. On the other hand, firms used to operating in highly corrupt home countries might not perceive that their costs increase in a foreign country that resembles their home country even if there is high asset specificity.

The following table shows how the combined causes of transaction cost and corruption in the host country affect foreign firms headquartered in countries either more or less corrupt than a highly corrupt host country.



**Table 1: Expected perceived corruption costs for foreign investors in different relative home and host country corruption levels**

Type of Investor	Causes of Perceived Costs			
	Bounded Rationality	Opportunism	Uncertainty	Asset Specificity
<b>Home Country More Corrupt than Host Country</b>	Perceived costs will not increase due to information asymmetry created by corruption (because host environment resembles that of the home environment)	Perceived costs will not increase due to the opportunism of host country actors due to corruption	Uncertainty resulting from corruption will not be perceived to be high in the host country	Perceived costs will not increase due to safeguards needed to protect assets in a corrupt host environment
<b>Home Country Less Corrupt than Host Country</b>	Perceived costs will increase due to information asymmetry created by corruption	Perceived costs will increase significantly due to the opportunism of host country actors due to corruption	Uncertainty resulting from corruption will be perceived to be high in the host country	Perceived costs will increase significantly due to safeguards needed to protect assets in a corrupt host environment

## 2.5 Criticism of the Transaction Cost Theory to Analyse Corruption and its Effect on FDI

Even though the TCT has the ability to study much of the FDI decisions, it still has its share of deficiencies. First of all, the TCT assumes that the main goal of the economic actors is to minimise transaction costs related with operations abroad (Madhok, 1997) but it does not take into the influence of local or foreign competitors in such firm's operations (Dunning, 1981). Also, since the TCT's unit of analysis is the transaction, variables concerning the evaluation of the potential foreign location, such as the levels and dimensions of corruption, are not included in the analysis.

Furthermore, the TCT approach to analyse FDI bases its assumptions on transactional market imperfections and explains internationalisation based on the boundaries of the firm. Therefore, the main argument of this theory explains why cross-border transactions of intermediate products are organised by hierarchies

instead as determined by the market. In other words, the TCT theory argues that MNEs will undertake FDI up to the point where the benefits of further internalisation are surpassed by the costs (Buckley, 1988). Nonetheless, this approach does not take into account the characteristics of the foreign location as compared to the advantages an MNE might have. For that reason, Dunning (1981) argued that in order to understand FDI activities three elements should be analysed: ownership-specific, Internalisation, and Location advantages.

## **2.6 Explaining How Combinations of Corruption levels (low vs. high) in the host and home countries Affect the Attraction of FDI Using Dunning's OLI Paradigm**

Dunning used the transaction cost theory as a predictive model by proposing that the form and competitiveness of an MNE's international operations depend crucially upon the configuration of three elements (Rugman & Verbeke, 1992). The three elements of the transaction cost theory of the multinational enterprises are: Ownership, Locational, and Internalisation advantages.

Dunning's (1980; 1981; 1988; 1992) eclectic paradigm might be the most comprehensive framework to explain reasons for FDI (Ramasamy & Yeung, 2010). The eclectic paradigm, also known as the OLI paradigm, asserts that there are three factors that determine international activities of MNEs. These factors are: Ownership (O) advantages, internalisation (I) advantages, and locational (L) advantages. Within this context, the OLI paradigm explains outward FDI and by suggesting that MNEs must develop unique and competitive O advantages at their home countries and then transfer them to a foreign market (based on L advantages) via FDI, which permits the MNE to internalise such O advantages (Rugman, 2010). In other words, the O advantages explain who will undertake FDI; the I-advantage explains the mode on which international production will occur; and the L advantage explains where FDI will flow to.

The eclectic paradigm further claims that each of the three firm-specific advantages and the arrangement among them is likely to be context specific (Dunning, 2000). Dunning also states that the significance of these advantages may vary depending on the industry, region, and country that is being analysed. For this reason, Dunning (2000) argues that the eclectic paradigm would be best regarded as a framework for analysing FDI activities instead of as a predictive theory of the MNE. Furthermore, there has been said that no single theory can fully incorporate all kinds of MNE foreign activities since their motivations and expectations of such activities will be different for different firms (Verbeke, 2009). Therefore, Dunning (2000) recommends that when conducting research with the help of the OLI paradigm such research should specify the context in which the relationship between the OLI factors is being examined.

The eclectic paradigm, according to Luiz and Charalambous (2009), is particularly useful to analyse MNEs FDI activities because it offers a synthesis of other models and in addition, it emphasises the ownership ‘O’ and location ‘L’ variables central to the study of the internationalisation of firms. The OLI paradigm also provides a holistic framework to analyse the importance of factors that influence the initial internationalisation of MNEs and their later activities (Dunning & Robson, 1987). The framework also enables comparison between different theories by creating a common ground between various approaches and explaining specific questions that scholars have asked (Cantwell & Narula, 2001).

### **2.6.1 Ownership Advantages**

In order to explain international production several threads of economic and business theories affirm that for MNEs to begin operations abroad they must possess some kind of specific, unique, and sustainable competitive advantages. These unique ownership (O) advantages (also called competitive or monopolistic advantages) might compensate for the added costs related with setting up and running operations abroad while local firms do not incur in such costs (Stoian & Filippaios, 2008). In

order to exploit these O advantages abroad MNEs should choose to transfer them within their own organisation rather than selling them or the right to use them to foreign-based firms (Dunning, 1988). This suggests that MNEs notice that foreign markets are not the most appropriate settings for transacting intermediate services or goods (Dunning, 1988).

Since the eclectic paradigm was first proposed it was assumed that O advantages reflected the resources and capabilities of the home countries of investing MNEs. Based on this it can be said that FDI would only happen when the benefits of exploiting O advantages from a foreign location offset the opportunity costs of doing so (Dunning, 2000).

Dunning (2000) says that since the 1960s, the literature has identified three main types of O specific advantages:

- Advantages relating to the ownership and exploitation of monopolistic power, as described by Hymer (1976). These advantages, according to Dunning (2000), are supposed to arise from creating barriers to entry to final product markets by MNEs that do not possess them.
- Advantages unfolding from the proprietorship of a bundle of rare and sustainable resources and capabilities that reflect a superior technical efficiency of a particular MNE relative to those of its competitors. These advantages are supposed to arise from creating a kind of barrier of entry to intermediate or factor product markets by MNEs that do not possess them (Dunning, 2000).
- Advantages related to the know-how of managers to recognise, evaluate, and exploit capabilities and resources from around the world and coordinate them with existing resources and capabilities under their authority in a manner that best represents the interests of their firm (Dunning, 2000).

Even though Dunning received criticism that the OLI paradigm was being used as a shopping list (Dunning, 2000), the eclectic paradigm is still useful to analyse a firm's specific advantages that allow it to compete overseas. One of the most important advantages a firm must possess is managerial know-how. In that same line of thought, the eclectic paradigm argues that some of these O advantages should also include technological knowledge and possession and/or access to finance. According to Dunning (1988), before deciding to invest abroad, firms must have such unique advantages to allow them to overcome the costs of operating in a foreign environment.

Based on the above definitions of O advantages, this particular research claims that firms based on highly corrupt home countries might have a particular O advantage when deciding to invest in highly corrupt host countries when compared to MNEs without such knowledge. On the other hand, firms from home countries with lower corruption levels than the host country might not have such advantages. Therefore, firms from home countries with lower levels than the host country might see their transaction costs increase when operating in such countries, whereas firms with such advantages might not.

Furthermore, while creating knowledge of how to operate in a highly corrupt environment might be an O advantage to firms, another aspect that should be taking into account is the damage that the image of a company might suffer from operating in a highly corrupt foreign environment. Even though it can be argued that any company might be able to develop and transfer knowledge of how to deal with corruption, those firms headquartered in home countries with low corruption levels might be more concerned about the potential costs to their image if they operate in a country considered highly corrupt.

### 2.6.2 Internalisation Advantages

Internalisation, I- specific, advantages arise when a firm has developed a set of competitive O specific advantages, and the immobile attributes of a foreign location (L advantages) permit finding value-added or asset-augmenting activities in such place and this firm decides to undertake such activities within itself rather than letting another firm to perform them (Dunning, 2000). In other words, internalising production will occur when an MNE believes that it is more convenient to transfer its O advantages within the firm across borders than selling it to a third-party (Stoian & Filippaios, 2008). In the words of Dunning himself, the internalisation of O advantages will occur when the international market is not the most appropriate method for transacting intermediate goods or services (Dunning, 1993).

The internalisation theory has provided a dominant explanation of why MNEs choose to participate in FDI rather than sell or buy intermediate products via a third party. The Internalisation theory, as proposed by Buckley and Casson (1976), Rugman (1981), and Hennart (1982), is a theory at the firm-level that explains why MNEs will exercise ownership control over an intangible knowledge-based, firm-specific advantage (Rugman, 2010). Such knowledge advantage, according to Rugman (2010), result from a transaction cost economics explanation on which the public good nature of such knowledge is alleviated by means of the hierarchy of an MNE overcoming this situation of a market failure.

Building on earlier studies, Anderson and Gatignon (1986) propose a model based on transaction costs analysis in order to explain why an MNE would own and manage a facility in a foreign location instead of using other supply agreements with local firms already operating in such market. Their model blends components of contract law, industrial organisation and organisation theory. Based on their study, Anderson and Gatignon (1986), assert that MNEs will use a low level of control to operate in a foreign location unless the risks and transaction costs related with this option are too high. However, different MNEs might perceive different risks in different locations.

For this reason, this study proposes that the intangible knowledge that MNEs headquartered in highly corrupt countries can be internalised and exploited in a highly corrupt foreign location. On the other hand, firms without such knowledge might struggle to adapt to generate the knowledge to cope with high levels of corruption abroad.

### **2.6.3 Locational Advantages**

Until recently neither the economics nor the business literature had paid much attention to how a specific location affected the emergence and growth of MNEs cross-border activities (Dunning, 1998). Instead, research was focused on explaining production within a specific location or how this location affected the competitiveness of investing MNEs. However, some context-specific theories of geographical distribution of FDI and the placement of particular value-added activities of MNEs have been developed since at least the 1930s (Dunning, 2000). Dunning (2000) explained that some of these ‘partial’ theories include the locational component of the product cycle theory (Vernon, 1966), the ‘follow my leader’ theory (Knickerbocker, 1973), and the risk diversification theory (Rugman, 1979).

Despite such early attempts to describe the location of FDI the question of where FDI is located based on a MNEs O and I advantages was not fully explored until the eclectic paradigm was put forward. The OLI paradigm acknowledged the importance of locational (L) advantages of countries as determinants of foreign production of MNEs taking into account a firm’s particular advantages (Dunning, 1998). Nevertheless, the rise of the knowledge based global economy and asset augmenting FDI has required scholars to re-visit the issue of the placement of MNE activities and to the competitive advantages of regions and/or nations. According to Buckley et al., (2007), FDI location is determined by three primary motivations:

1. Foreign-market-seeking
2. Efficiency-seeking (cost reduction)

### 3. Resource-seeking (this includes a subset also known as strategic-asset seeking)

This suggests that different selection criteria pertain for projects with different motivations. Therefore, identifying the variables that influence the most particular investment is paramount (Habib & Zurawicki, 2002). Based on this premise, this study argues that the level of corruption of the host country is an important aspect for firms to take into account when establishing activities abroad. However, the level of corruption of the host country alone might not be enough to analyse how corruption affects the attraction of foreign investment to certain location. Instead, this study argues that the ‘distance’ between the corruption levels of home and host country might be more important indicator to see whether or not corruption has an effect on FDI when investing in a highly corrupt foreign country.

The L advantages play an important role when analysing cross-border activities since they can define the attractiveness of a foreign market for a particular MNE (Dunning, 1998). Issues such as institutional differences, size of the market, purchasing power, the rate of inflation, unemployment, and corruption gain more importance when doing business abroad than domestically. Moreover, advancing the knowledge of the L advantages and their influence on FDI will expand our knowledge of international activities of the MNE in an ever-increasing international business context. This study seeks to advance the knowledge on the L advantages and their influence on FDI. To do so, corruption and corruption distance are included among the factors of the attractiveness of certain location.

#### **2.6.3.1 Foreign Market Attractiveness**

The role of market attractiveness refers to the preconception that MNEs seek foreign markets that offer a strong potential for growth (Eaton & Tamura, 1994). According to Grosse and Trevino (1996), FDI theory proposes that FDI will go primarily to markets that are considered large enough to provide the economies of scale required



for production. This statement explains why FDI goes primarily to developed countries since most FDI has been historically market seeking (Grosse & Trevino, 1996). However, when testing determinants for FDI into Latin America, Trevino et al., (2002) found that host country GDP was a significant predictor of FDI in the region. Moreover, a study conducted by UNCTAD found that market size was the main determinant of FDI into the region (UNCTAD, 1994).

How attractive a foreign market is can be a very important determinant when analysing whether or not to establish operations abroad, but so is the level of corruption of the host country (Blanton & Blanton, 2007). However, based in the premise that not all foreign investors perceive risk in the same manner, it may be possible that some firms are not as concerned by corruption than others. This study argues that firms headquartered in countries with high levels of corruption might not suffer an increase in transaction costs due to corruption abroad. On the other hand, those firms headquartered in countries with low levels of corruption might see an increase in transaction costs when operating in highly corrupt foreign countries.

### **2.6.3.2 Corruption Distance**

The perceived cultural distance between a home and host countries can also be named ‘psychic’ distance. According to Nordstrom and Vahlne (1992, p. 3) psychic distance is comprised by “the factors preventing or disturbing the flow of information between potential or actual suppliers and customers.” One of the most widely accepted forms of psychic distance in the IB discipline is the difference in national cultures between the home and host country (Johanson & Vahlne, 1977). This difference in culture or the ‘cultural distance’ between home and host countries can have been a significant effect on an MNE when conducting operations abroad since it rises the transaction costs and risks associated with operating in an ‘unknown’ business environment (Brouthers & Brouthers, 2001).

While analysing the effects of cultural distance on MNEs most studies propose that as the cultural differences among a home and host country increase, the abilities of the MNE to operate in the host country decrease (Hennart & Larimo, 1998). These propositions are based on the argument that the greater the cultural distance between a home and host country the more difficulties a foreign manager will have to understand the values and norms of the foreign market (Tihanyi, et al., 2005).

In the case of corruption, current literature has explained that the greater the difference in corruption levels between a home and host country, the more FDI will be deterred (Habib & Zurawicki, 2002). However, we argue that it is not only the distance in corruption levels what might deter FDI but the direction of such distance. In other words, we argue that corruption distance might have a negative effect on FDI when the home country has lower levels of corruption than a highly corrupt host country. On the other hand, corruption distance might not have a negative effect on home countries that are considered more corrupt than a highly corrupt host country. This can be explained by the smaller psychic distance between highly corrupt home and host countries that are used to operating in these conditions, as opposed to the greater psychic distance between a highly corrupt host country and a home country with lower corruption levels that not only has less experience operating in a corrupt location but also might face higher pressures from their stakeholders to not engage in corruption abroad.

### **2.6.3.3 Inflation Rate**

The currency value of a country might be weakened by monetary policies or by economic instability. Currency devaluation might be the result of such policy variations and foreign investors should cover the costs to avoid transaction losses when the host country currencies devalue. Hence, *ceteris paribus* a stable real exchange rate is preferred by foreign investors to minimise exchange rate risks inherent to investing in a foreign location (Ciccarelli & Mojon, 2010). Furthermore, economies experiencing high rates of inflation tend to undermine sales and therefore,

market-seeking MNEs would avoid a foreign location experiencing high inflation (Kahai, 2004). Also, high rates of inflation can be a signal of economic uncertainty and of the host government's lack of capacity to impose an adequate monetary policy (Arbelaez & Ruiz, 2013).

Scholars have argued that high inflation, usually found in countries with high corruption, might have negative effects on the attraction of FDI (Asiedu, 2002). Moreover, high inflation rates have been presented as deterrents of FDI (Trevino, et al., 2004). In this study, we could see that an instable rate of inflation might increase costs of operating abroad to firms based in home countries with either higher or lower corruption levels than the host country.

#### **2.6.3.3.4 Unemployment Rate**

Multinationals interested in establishing operations abroad should have in mind the characteristics of the local workforce they need to employ in the proposed area. However, the association between unemployment rate and FDI inflows to a region is mixed. According to Billington (1999), one of the most important variables explaining the attraction of FDI is the availability of labour. In order to test his proposition, Billington (1999) argues that the greater unemployment rate of a host location, the greater the FDI inflows since the foreign MNE can have a greater pool of possible employees. Also, the unemployment levels will make people have a higher value on their existing employment or any potential future job. On the other hand, Ray (1989), the unemployment rate in a foreign location decreases the degree of FDI. Pearson et al., (2012) also argue that high unemployment rates are related to socio-economic issues such as high crime rates that might deter FDI since MNEs may not be allured to having a lasting interest in such an environment. Despite the debate of whether or not the unemployment rate encourages or discourages FDI, its importance as an MNE determinant is rarely disputed in current literature (Tsai, 1994; Tuman & Emmert, 2004; Bengoa & Sanchez-Robles, 2003) and might have an equal effect on firms regardless of the corruption level of their home countries.

### **2.6.3.3.5 Quality of Infrastructure**

Researchers have used the number of fixed telephone lines and mobile telephones per 1000 people in a location as a proxy for the quality of infrastructure of a country (Kahai, 2011). The rationale explained for using the number of telephones used in a location to represent the quality of infrastructure is because countries with an adequate telecommunications infrastructure usually have similar quality in other aspects such as roads, and the Internet. Infrastructure, in this sense, covers several dimensions of physical assets such as roads, sea ports, and telecommunications, to institutional ones, such as accounting and legal services (Kahai, 2011).

Nevertheless, nowadays due to the increase of internet users and the decrease of telephone lines, it might be appropriate to use a number of internet users as a proxy for quality of infrastructure. The rationale for taking the number of internet users as a proxy for infrastructure obeys to the fact that nowadays communications via internet are perceived as more important than traditional telephone ones (Choi, 2003). Furthermore, a region that does not have an appropriate access to the internet might deter FDI due to the problems for managers for communicating with their foreign subsidiaries.

### **2.6.3.6 Education Levels**

Education is a central element of a country's institutional environment since it offers socialising practises that prepare individuals to be a part of a society (Meyer, 1977; Trevino, et al., 2008). Education is also an important aspect that central in the transmission of societal norms and beliefs from generation to generation (Turner, 1997). According to Trevino, et al., (2008), educational levels in a location have two main impacts on FDI inflows: to act as a proxy for quality labour because foreign investors should be interested in establishing operations in locations with available qualified human resources (as long as they are not too costly); and MNEs are also

attracted to locations with high levels of education since their operations often need more skilled labour than the rest of the economy.

While analysing the determinants of FDI educational attainment proved to be an important factor (Trevino, et al., 2008). Furthermore, Boresztein, et al., (1998) argues that developing countries are not attractive solely on the basis of low cost labour, but instead, they needed a minimum educational level of their human capital to attract inward FDI. In fact, Latin American countries that offer high levels of skilled labour receive larger amounts of FDI (Blanton & Blanton, 2007). For example, the decision of Intel to set up a plant in Costa Rica was partially motivated by the high levels of skilled labour available in the country (Jensen, 2006).

Therefore, a large pool of qualified labour force might be a strong determinant of FDI for companies headquartered at home countries with higher or lower corruption levels than the host country.

### **2.6.3.7 Human Development Index**

Scholars have long argued that measuring the attractiveness of a foreign location based solely on GDP does not capture the whole picture of such place. Instead, it has been claimed that focusing solely on GDP can come at the expense of other important factors that are needed to evaluate the attractiveness of a possible investment location (Stiglitz, 2006). Therefore, studies have used the United Nations Human Development Index (HDI) to capture the value of an array of factors that have been found to attract FDI (Globerman & Shapiro, 2003). This index measures not only GDP, population, and literacy, but also life expectancy at birth, all of which have been tested to be determinants of FDI in developing countries (Globerman & Shapiro, 2003). However, since firms located in home countries with high levels of corruption have operated in their local markets with low human development index, they might not mind it abroad. On the other hand, firms from countries with above

average HDIs might see their costs of operating abroad increase abroad in countries with low HDI due to the lack of experience operating in such conditions.

#### **2.6.3.8 Rule of Law**

Besides a strong host economy, multinationals require a stable environment on which to conduct operations outside their home country. However, several developing countries lack the development of regulatory institutions that protect the interests of foreign multinationals (Meyer, 2001), which results in ambiguity of the rules to follow (Roy & Oliver, 2009) and thus, decreasing FDI inflows. Furthermore, underdeveloped institutions do not provide strong enough bases for fostering financial, organisational and technological resources that MNEs need to compete in foreign markets (Hitt, et al., 2000). Therefore, MNEs prefer to invest in those countries where their basic rights are protected by an adequate rule of law.

In the case of corruption, it can be argued that the weaker the rule of law the stronger the corruption level of a country. Therefore, it also could be argued that a weak rule of law can decrease FDI flows to certain location. However, this might be partially true since firms operating under similar conditions at home might not be as impacted as firms without such problems when operating abroad.

#### **2.6.3.8 Economic Freedom**

Even though researchers agree that variables such as market size and educational attainment are significant determinants of FDI, the role of economic freedom has seldom been tested. However, according to Bengoa and Sanchez-Robles (2003), the economic freedom variable is of utmost importance when researching FDI to Latin America. Furthermore, Bengoa and Sanchez-Robles (2003) found that the Economic Freedom Index is a significant predictor of FDI to Latin America. This result is based on the idea that the more economic freedom a country enjoys the better institutional framework it offers foreign investors regardless of the investors' home country corruption levels.

### **2.6.3.9 Bureaucracy**

According to Globerman and Shapiro (2003), government effectiveness (the measurement of time spent dealing with red tape and bureaucracy) in a foreign location is one of the most important factors when studying FDI inflows, especially when the host country or countries is considered developing. This can be explained because the time spent dealing with bureaucratic procedures in a foreign location delays the expected utility that potential profits can provide (Baniak, et al., 2005). Therefore, Bénassy-Quéré, et al. (2007) argue that the time spent dealing with bureaucratic procedures in a foreign location has a strong negative influence on FDI flows and it might serve as an incentive to MNEs to engage in corrupt deals to circumvent such bureaucratic procedures. However, since some firms have developed expertise about operating under highly bureaucratic systems at home, they might not be as affected when operating abroad as compared to those firms without such knowledge.

## **2.7 Explaining How Combinations of Corruption levels (low vs. high) in the host and home countries Affect the Attraction of FDI Using Dunning's OLI Paradigm (Ownership Advantages)**

As mentioned previously, Dunning proposed that firms needed three variables to explain the internationalisation of a firm's activities. The first of those advantages, according to Dunning, are ownership specific advantages (Dunning, 1988). Dunning argued that to internationalize a firm must possess O-specific advantages related to asset advantages and transaction costs minimising advantages (Dunning, 2000). When analysing these O-specific advantages according to the corruption level of the home country, interesting issues arise.

### **2.7.1 Ownership Specific Advantages when Host Corruption and Home Corruption is Low**

When analysing O-specific advantages of firms with home countries with low corruption levels investing in foreign locations with similar corruption levels, it can be argued that the transaction costs associated with those activities are minimum. This assertion can be justified because those firms might have developed managerial know-how, technological knowledge, access to finance, and the ability to recruit employees in a foreign country. Moreover, since both home and host countries have low corruption levels, the investing firms do not face increase in possible transaction costs due to transacting with partners in highly corrupt foreign countries, which can minimise costs in protecting the reputation of the company, deal with uncertainty, and cope with opportunism abroad.

### **2.7.2 Ownership Specific Advantages when Host Corruption is Low and Home Corruption is High**

While firms from countries with low corruption levels investing in similar foreign countries do not have to develop many O-specific advantages, if they decide to invest in countries with high levels of corruption they do need to do so. Since these firms are generally from developed countries, scholars argue that they have developed managerial know-how, technological knowledge, sound financials, ability to transfer knowledge and to recruit foreign workforce that can be exploited in other countries with lower development levels (Asiedu, 2002). Nevertheless, these firms might be deterred from investing in host countries with high levels of corruption due to the costs associated with this institutional environment (Cantwell & Narula, 2001).



**Table 2: Explaining How Combinations of Corruption levels (low vs. high) in the host and home countries Affect the Attraction of FDI Using Dunning's OLI Paradigm**

**Ownership Specific Advantages**

<b>Dunning Factor 'O'</b>	<b>A Corruption: Host Low Home Low</b>	<b>B Corruption: Host Low Home High</b>	<b>C Corruption: Host High Home Low</b>	<b>D Corruption: Host High Home High</b>
<b>Host Country</b>				
Managerial know-how	Firm has it Decrease in TC	Firm has it Decrease in TC	Firm does not have it Increase in TC	Firm does not have it but does not need it No effect on TC
Technological knowledge	Firm has it Decrease in TC	Firm has it Decrease in TC	Firm does not have it Increase in TC	Firm does not have it but does not need it No effect on TC
Possession and access to finance	Firm has it Decrease in TC	Firm has it Decrease in TC	Firm does not have it Increase in TC	Firm does not have it but does not need it No effect on TC
Creation of Knowledge of how to operate in a highly corrupt environment	Firm does not have it but does not need it No effect in TC	Firm does not have it Increase in TC	Firm has it but does not need it No effect on TC	Firm has it Decrease in TC
Transferring of the knowledge of how to deal with corruption	Firm does not have it but does not need it No effect in TC	Firm does not have it Increase in TC	Firm has it but does not need it No effect on TC	Firm has it Decrease in TC
Reputation of the company (image created and in need to be maintained)	Firm has it Decrease in TC	Firm has it Increase in TC	Firm does not have it but does not need it No effect on TC	Firm does not have it but does not need it No effect in TC
Ability to recruit employees in a foreign country	Firm has it Decrease in TC	Firm has it Decrease in TC	Firm has it Decrease in TC	Firm has it Decrease in TC
Use of local collaborators	Firm has it Decrease in TC	Firm has it Decrease in TC	Firm has it Decrease in TC	Firm has it Decrease in TC
Knowledge of how to deal with the uncertainty inherent to developing countries	Firm does not have it but does not need it No effect on TC	Firm does not have it Increase in TC	Firm has it but does not need it No effect on TC	Firm has it Decrease in TC
Knowledge of how to cope with opportunism from local partners and government officials in developing countries	Firm does not have it but does not need it No effect on TC	Firm does not have it Increase in TC	Firm has it but does not need it No effect on TC	Firm has it Decrease in TC

The reasons for these firms from headquartered in countries with low corruption levels to be deterred by high levels of corruption in foreign countries can be explained by the lack of knowledge of how to operate in such conditions (Cuervo-

Cazurra, 2006) that raise the perceived transaction costs associated with such operations (Driffield, et al., 2013). Such lack of knowledge, or O-specific advantages, can be created due to the lack of experience in operating in a highly corrupt foreign environment and the lack of knowledge of how to deal with opportunism. It can also be argued that firms from home countries with low corruption levels might be deterred to investing in highly corrupt foreign countries by the possible detrimental effect on their reputation that they may suffer by conducting business in such highly corrupt foreign countries (Cuervo-Cazurra & Genc, 2008).

### **2.7.3 Ownership Specific Advantages when Host Corruption is High and Home Corruption is Low**

The international business discipline has a long tradition of analysing how firms internationalise. However, the studies tackling this issue have generally analysed firms from developed countries investing in other developed countries and later in developing ones (Brouthers, 2013). This point of view is explained because this is how the patterns of investment was (Rodriguez, et al., 2006). However, in the last decades a new phenomenon has emerged and that is firms from developing countries investing in countries considered developed.

While analysing how corruption in the host country might affect firms investing in foreign locations with lower levels of corruption than their home country might seem unimportant, important issues still arise. Several studies argue that firms from developing countries, usually highly corrupt, have not developed enough O-specific advantages to operate abroad; however, these studies have taking into account only O-specific advantages that emanate from developing technological and managerial know-how, and the possession and access to finance. Nevertheless, it can be argued that these firms have developed certain O advantages that might not be traditional such as the knowledge of how to operate in highly corrupt foreign environments. However, firms investing in host countries with lower levels of corruption than their

home country might not take advantage from such knowledge and should develop other O advantages; nonetheless, this issue is beyond the scope of this study.

#### **2.7.4 Ownership Specific Advantages when Host Corruption and Home Corruption is High**

As previously mentioned, the IB discipline has only until recently begun to analyse the internationalisation process of firms from developing countries, and this includes the now called ‘South-South’ FDI. South-South FDI refers to firms from developing countries investing in other developing countries. This issue has been popular with scholars due to the fact that these firms do not always follow traditional patterns of internationalisation. In this sense, current literature has not yet fully explained how high levels of corruption in the host country might affect a firm from a highly corrupt home country.

According to Cuervo-Cazurra and Genc (2008), firms from developing countries might not have traditional O-specific advantages such as managerial and technical know-how or they might lack financial strength, but these firms may possess specific knowledge of how to operate in other countries with a similar institutional environment. However, the extant literature has not yet fully explained if the same situation can be said specifically about corruption. However, based on existing literature it is plausible that firms from highly corrupt home countries might not face an increase in transaction costs when investing in other highly corrupt countries due to the knowledge they have developed regarding how to operate under such conditions.

#### **2.7.5 Overall effects of Host and Home Corruption on Ownership Specific Advantages**

While there have been several studies analysing how firms internationalise, there is still a lack of understanding regarding how firms react when corruption is present in foreign host countries. Dunning’s OLI paradigm argues that firms must develop O-specific advantages that will help them overcome their liability of foreignness and

compete against indigenous firms. Such O-advantages can be seen in the form of asset advantages, or transaction cost minimizing advantages. Taking into account the corruption level of the home country as compared to that of the host country, this study argues that firms from home countries with lower levels of corruption than the host country might perceive the costs of operating in a highly corrupt host country very high. On the other hand, those firms based in highly corrupt home countries might not perceive the costs of operating in other highly corrupt country to be a deterrent for investment.

This assertion can be made based on the O-specific advantages that different firms have developed and how they use them when operating abroad. While firms from countries with low levels of corruption, usually developed countries, have developed O-specific advantages in areas as managerial and technical know-how, and in the access to finance, they might perceive that operating in a highly corrupt foreign country might increase their transaction costs. On the other hand, firms from highly corrupt home countries might not have such know-how or such sound financials; they might have developed knowledge of how to operate in a highly corrupt home country and might have been able to use that knowledge when operating in a foreign country with a similar environment.

## **2.8 Explaining How Combinations of Corruption levels (low vs. high) in the host and home countries Affect the Attraction of FDI Using Dunning's OLI Paradigm (Internalisation Advantages)**

The internalisation theory, as developed by Buckley and Casson (1976) and Rugman (1981) is a theory that explains at the firm level why an MNE will exercise proprietary control over an O-specific advantage when operating overseas. According to the internalisation theory, all the O-advantages emerge from a transaction costs explanation, on which the public nature of knowledge is “remedied through the hierarchy of a firm overcoming this situation of market failure” (Rugman, 2010, p. 3).

**Table 3: Internalisation Specific Advantages**

<b>Dunning Factor 'I'</b>	<b>A Corruption: Host Low Home Low</b>	<b>B Corruption: Host Low Home High</b>	<b>C Corruption: Host High Home Low</b>	<b>D Corruption: Host High Home High</b>
<b>Host Country</b>				
Lower transaction costs	Firm has it Decrease in TC	Firm has it Decrease in TC	Firm does not have it Increase in TC	Firm does not have it Increase in TC
Protection of property rights	Firm has it Decrease in TC	Firm has it Increase in TC	Firm does not have it but does not need it No effect in TC	Firm does not have it but does not need it No effect in TC
Protection of know-how	Firm has it Decrease in TC	Firm has it Increase in TC	Firm does not have it but does not need it No effect on TC	Firm does not have it but does not need it No effect in TC

### **2.8.1 Internalisation Specific Advantages when Host Corruption and Home Corruption is Low**

Since the internalisation part of the OLI paradigm deals with the transaction costs of the firm when operating abroad, it is important to analyse how corruption affects the MNE's decision of internalising an operation or transact it within the market. When an MNE from a home country with low corruption levels invests in foreign country with a similar corruption level, such firm does not face increased transaction costs due to this institutional factor abroad. Therefore, the firm can focus on lowering its transaction costs by internalising as many operations as possible without worrying too much about how to protect their proprietary rights or their know-how due to corruption.

### **2.8.2 Internalisation Specific Advantages when Host Corruption is Low and Home Corruption is High**

As previously stated, firms headquartered in countries with low corruption levels investing in similar countries with low corruption do not face the need to incur in high costs to protect their proprietary assets due to corruption abroad. Also, the same could be argued for firms based in countries with high levels of corruption investing

in countries with low corruption levels. For that reason, table 3 presents that firms based in highly corrupt countries do not face high transaction costs due to corruption in home countries with low corruption. Nevertheless, other institutional aspects of the host country will affect internalisation costs, but those are beyond the scope of this study.

### **2.8.3 Internalisation Specific Advantages when Host Corruption is High and Home Corruption is Low**

Studies focusing on how high corruption in the host country affects FDI have generally agreed that corruption deters FDI (Judge, et al., 2011). These conclusions have been reached through various lenses, but mainly because of the increase in real and perceived transaction costs that MNEs face when operating in locations considered as corrupt (Cuervo-Cazurra, 2006). These studies have analysed this issue studying how MNEs from developed countries react to the additional costs imposed by corruption abroad.

Therefore, FDI from home countries with low corruption levels would decrease FDI to locations with higher corruption because of the high costs needed to internalise such firm's operations abroad. These costs include transaction costs needed to protect a firm's proprietary rights, which are responsible for a firm's competitive advantage. Also, these costs include higher costs in protecting a company's know-how. This means that since firms with low levels of corruption at home do not need to take into account these costs when operating in a similar environment abroad, they need to do so when operating in a highly corrupt host country (Rodriguez, et al., 2006).

### **2.8.4 Internalisation Specific Advantages when Host Corruption and Home Corruption is High**

While the IB discipline has not yet fully explained the South-South FDI phenomenon, various studies have shed light to this process. One of the most intriguing aspects of South-South FDI is that it has been argued that firms from the 'South' have not been

able to develop many I-specific advantages (Cuervo-Cazurra & Genc, 2008). Nevertheless, this claim has been made by comparing I-specific advantages of ‘South’ firms to their counterparts based in developed countries. However, this study argues that while it may be true that ‘South’ firms have not developed I-specific advantages when operating abroad, they might have developed others. These I-advantages for ‘South-South’ FDI can be that these firms are used to operating in highly corrupt home countries, and therefore do not face an increase in their transaction costs when internalising operations in foreign countries with similar corruption levels.

### **2.8.5 Overall effects of Host and Home corruption on Internalisation Specific Advantages**

The internalisation section of the OLI paradigm deals with an MNE’s mode of entry to a foreign market. In other words, the I specific advantages explain whether a foreign firm has developed knowledge of how to internalise their operations abroad as opposed to transact within the market. When analysing how high corruption in the host country several studies have argued that corruption deters FDI (Judge, et al., 2011). However, this claim has been made without considering the corruption level of the home country as compared to the host country.

This study argues that corruption will affect FDI depending on the corruption level of the home country as compared to the host country. Therefore, firms that do not have internalised knowledge of how to deal with corruption abroad due to the lack of corruption at home will see their transaction costs increase when operating in a highly corrupt home country. On the other hand, firms based in countries with high levels of corruption might have developed I-specific advantages that allow them to reduce the high costs of operating in a highly corrupt foreign country.

## 2.9 Explaining How Combinations of corruption levels (low vs. high) in the host and home countries Affect the Attraction of FDI Using Dunning's OLI Paradigm (Location Advantages)

The third element of the OLI Paradigm, location 'L' advantages, has received renewed attention because of recent changes in the geographical activities of MNEs and because of the linkages of the spatial aspects of the firm value-added activities to firm competitiveness (Dunning, 1988; Habib & Zurawicki, 2002). This suggests that the criteria to select different locations might have different motivations depending on how a given firm assesses such locations. Therefore, assessing how corruption affects the allocation of FDI might follow the same rationale. In other words, how firms assess the risk associated with corruption in a foreign location might depend on how such firm has interacted with corruption at home.

**Table 4: Location Specific Advantages**

<b>Dunning Factor 'L'</b>	<b>A Corruption: Host Low Home Low</b>	<b>B Corruption: Host Low Home High</b>	<b>C Corruption: Host High Home Low</b>	<b>D Corruption: Host High Home High</b>
<b>Host Country</b>				
Geographical position	?	?	?	?
Human development index	Similar to home country No effect on TC	Low Compared to home country Increase on TC	High Compared to home country Decrease on TC	Similar to home country No effect on TC
Exchange rate	Similar to home country No effect on TC	Low Compared to home country Increase on TC	Low Compared to home country Decrease on TC	Similar to home country No effect on TC
Educational attainment	Similar to home country No effect on TC	Low Compared to home country Increase on TC	High Compared to home country Decrease on TC	Similar to home country No effect on TC
Inflation	Similar to home country No effect on TC	High Compared to home country Increase on TC	Low Compared to home country Decrease on TC	Similar to home country No effect on TC
Quality of infrastructure	Similar to home country No effect on TC	Low Compared to home country Increase on TC	High Compared to home country Decrease on TC	Similar to home country No effect on TC
Purchasing power of population	Similar to home country No effect on TC	Low Compared to home country Increase in TC	High Compared to home country Decrease in TC	Similar to home country No effect in TC



Bureaucracy	Similar to home country No effect on TC	High Compared to home country Increase in TC	Low Compared to home country Decrease in TC	Similar to home country No effect in TC
Corruption level	Similar to home country No effect on TC	High Compared to home country Increase in TC	Low Compared to home country Decrease in TC	Similar to home country No effect in TC
Distance between corruption level of home and host country	Similar to home country No effect on TC	High Compared to home country Increase in TC	Low Compared to home country Decrease in TC	Similar to home country No effect in TC
Distance AND direction of distance between corruption level of home and host country	Similar to home country No effect on TC	GAP	Low Compared to home country Decrease in TC	GAP

### 2.9.1 Location Specific Advantages when Host Corruption and Home Corruption is Low

The IB discipline has agreed that the physical location of a foreign country can be considered as an L-specific advantage (Dunning, 1998). Nevertheless, this assertion has to be assessed on a ‘case-by-case’ basis. As a consequence, table 4 cannot provide a generalised prediction of how different locations affect the attraction of FDI when both the home and host countries have low levels of corruption. On the other hand, an analytical evaluation of how the different variables interact when analysing FDI from host countries with low corruption investing in similar host countries can be performed.

When analysing FDI flows between non-corrupt countries, interesting aspects can be observed. Since countries with low levels of corruption are usually considered developed (Rodriguez, et al., 2006), it can be assumed that both, the home and host countries have similar levels of human development indices, exchange rates, inflation rates, infrastructure quality, bureaucracy, and corruption levels. Therefore, no effects on transaction costs can be seen.

### **2.9.2 Location Specific Advantages when Host Corruption is Low and Home Corruption is High**

As previously stated, there has been a great deal of studies analysing how high corruption affects the attraction of FDI. Usually, those studies analysed FDI flows from home countries with low levels of corruption to host countries with high corruption. These studies conclude that corruption in the host country has a detrimental effect on the attraction of FDI. This claim is made based on the effect that the different levels of corruption between home and host countries have on specific transaction costs. These costs are presented in table 4 and are explained as follows.

As explained in table 4, FDI from home countries with low levels of corruption (usually developed) is deterred by corruption abroad (usually developing countries). This is explained by the difference in different variables that increase the transaction costs of these activities. These variables see an increase in the transaction costs due to the differences in the human development indices, volatility of the exchange rate, low educational attainment, high inflation, low quality of infrastructure, low purchasing power of the population, high bureaucratic systems, and high corruption levels inherent to foreign locations that are considered developing.

### **2.9.3 Location Specific Advantages when Host Corruption is High and Home Corruption is Low**

Table 4 also presents how variables of L specific advantages are affected when FDI flows from home countries with higher levels of corruption than the host countries. Since home countries with low levels of corruption are considered developed, variables such as the human development index, exchange rate, educational attainment, inflation, infrastructure, purchasing power of the population, and corruption levels have better levels than the home country. Therefore, these variables do not increase transaction costs on FDI. Nonetheless, firms from developing

countries do face high transaction costs when conducting such activities, but that topic is beyond the scope of this research.

#### **2.9.4 Location Specific Advantages when Host Corruption and Home Corruption is High**

Even though there have been several studies analysing how corruption in a specific location affects FDI, studies dealing with FDI flows from developing countries to other developing countries are scarce. However, not all foreign investors perceive risk in the same manner (Cuervo-Cazurra, 2006). Therefore, those firms based on highly corrupt home countries would not mind high corruption abroad, and thus, high corruption in the host country can be perceived as an L specific advantage for firms headquartered in countries with high levels of corruption.

This study argues that high corruption in the host country can be considered an L-specific advantage due to the low transaction costs faced by foreign investors used to operating under such conditions at home. The argument is supported by the argument presented in table 4. This table shows how home countries with high levels of corruption investing in similar foreign countries have the same levels of human development, exchange rates, educational attainment, inflation, infrastructure, bureaucracy, and corruption levels. However, this claim has not been fully researched by extant literature in the subject.

#### **2.9.5 Overall effects of Host and Home Corruption on Internalisation Specific Advantages**

In the present study, the effect of corruption on FDI was explained depending on the level of corruption of the home country as compared to that of the host country. Corruption creates Previous studies have argued that corruption, an important L-specific advantage, discourages FDI. However, by separating home countries by their level of corruption as compared to the host country, this study argues that corruption does not impact on all foreign investors equally, because foreign investors do not face the same costs when dealing with corruption abroad. Investors from countries

with lower levels of corruption at home might be deterred by high corruption abroad due to the high transaction costs associated with corruption. However, those firms used to operating in highly corrupt home countries might not perceive an increase in the transaction costs of operating in a similar foreign country.

### **2.10 Lack of a Theoretical Framework to Analyse how Corruption Affects the Attraction of FDI to a Highly Corrupt Host Location**

In order to analyse how corruption affects the attraction of FDI to a highly corrupt host location based on the levels of corruption of the home countries, an extension of the existing theoretical framework is needed. Corruption and its effects on FDI have been studied through various theoretical lenses; however, transaction cost and the OLI paradigm are considered the two most powerful approaches to study this issue (Driffield, et al., 2013). For this reason, this study proposes a reconciliation between the transaction cost theory and the OLI paradigm in order to understand how corruption affects the attraction of FDI to a highly corrupt foreign location.

### **2.11 Reconciling the Transaction Cost Theory with the OLI Paradigm**

Dunning developed his Ownership-Location-Internalization paradigm (OLI) Building on the basic tenants of the TCT to analyse FDI activities. As stated before, unlike the pure TCT approach, the OLI paradigm embraces a wide variety of economic and social variables (Driffield, et al., 2013; Dunning, 1993); specifically, the economic costs caused by geographic distance including transport and tariffs and social costs arising from the unfamiliarity, relational and discriminatory hazards that foreign firms face in the host country (Eden & Miller, 2004; Zaheer, 1995). The economic-related costs have been reduced with the development of modern IT and globalization (Calhoun, 2002), and thus have been gradually downplayed in the IB literature. However, the social content of the costs has been developed in the form of the liability-of-foreignness (LoF) stream of research (e.g. Zaheer, 1995), and the hazards associated with LoF are viewed through the lens of institutional theory, employing the specific concept of institutional distance (Eden & Miller, 2004).

Therefore, this study will utilise the basic premises of the TCT and the three advantages of the OLI paradigm to analyse the impact of corruption on FDI attractiveness.

MNEs may use care when choosing host countries for their foreign subsidiaries because of greater uncertainty and difficulties, and the costs caused by uncertainties may put such MNEs in a disadvantage when competing with local firms. Ownership advantages enable MNEs to overcome liability of foreignness and newness; in particular, asset specificity, consisting of crucial part of ownership advantages in the paradigm (Rugman & Verbeke, 1992) that MNEs enjoy whilst local incumbents do not, can be exploited abroad to offset their disadvantages. Location-bound ownership advantages (OAs), defined as advantages that an MNE can exploit only in a particular location (Birkinshaw, et al., 1998) or set of locations (Anand & Delios, 1997) cannot be transferred with ease and significant adaptation is needed if an MNE would like to utilise them in a different location (Stoian & Filippaios, 2008). However, non-location-bound OA can be transferred globally at a low marginal cost and can be used in foreign operation without a significant adaptation (Harzing, 2002).

Analysed through the TCT lens, corruption in a host location can be seen in part as a non-location-bound OA (Cuervo-Cazurra & Genc, 2008). Therefore, in a cost/benefit manner, depending on the causes of transaction costs and the knowledge of foreign investors about how to decrease them, corruption will deter foreign investors if the costs of the potential deal exceed its benefits (Rose-Ackerman, 2008). This might suggest that while some firms with no experience in dealing with corruption at home might be at a disadvantage when operating in highly corrupt foreign countries, the same might not be true for those firms familiar with operating in highly corrupt home countries. For MNEs with knowledge of dealing with corrupt environment at home, they may be encouraged by their location-bound-ownership advantages and willing to invest in similar locations. Thus, when analysing how corruption affects FDI, it is important to know if the knowledge regarding how to cope with corruption may be

acquired at home, by some firms, and redeployed abroad without incurring in high costs.

Another important factor in Dunning's OLI paradigm is localisation 'L' advantages in the host country. MNEs locate foreign operations where operating costs can be minimised and firms internalise activities in overseas locations in order to lower costs derived from risk and uncertainty (Wang, et al., 2012). Acknowledging the lack of institutional content in the paradigm, Dunning (1998) enhanced the location dimension by including political risk, policies, regulations, cultural differences and exchange rates. MNEs contemplating FDI have to take the host country institutional characteristics into account, especially when analysing developing economies (Peng, et al., 2009), including the quality of institutions and the existence of corruption.

The issue of corruption arises when bad policies and/or inefficient institutions are set in place and groups or individuals seek to get around them (Svensson, 2005). Consequently, corruption can be seen as an outcome that reflects a country's legal, economic, cultural, and political institutions. Murphy et al., (1993) argue that corrupt behaviour can be institutionalised and thus becoming a normal practice in certain locations. Local levels of corruption are not only determined by the formal institution of the law and its enforcement, but also by informal social norms on what is acceptable. Research by Ufere et al., (2010) found the bribe-generating behaviour by entrepreneurs in Nigeria, which is governed by a well-embedded set of social norms, rules, routine, and power relations. Giving and taking a bribe may seem like a simple unskilled task, but a foreigner with limited knowledge of local laws and norms may risk exposure. The costs involved in establishing and maintaining legitimacy places MNEs at a competitive disadvantage (Eden & Miller, 2004). For example, local firms are most likely to reach corrupt deals with public officials, and have access to legislators; therefore they have an advantage over those without such access (Anechiarico & Jacobs, 1996).

This study argues that host country corruption has different effects on investors depending on their home country corruption level. This means that home countries with lower levels of corruption than a highly corrupt host country will be affected by corruption in the host country, while home countries with higher corruption levels than the host location will not. For MNEs headquartered in countries with lower levels of corruption than the host region, host country corruption represents more risk and uncertainty (and thus higher costs). Thus, this study contends that the host country corruption may have a negative association with inward FDI. Therefore, the following research hypothesis is put forward:

Hypothesis 1: Corruption distance will have a negative association with inward FDI when the home country has lower levels of corruption than the host country.

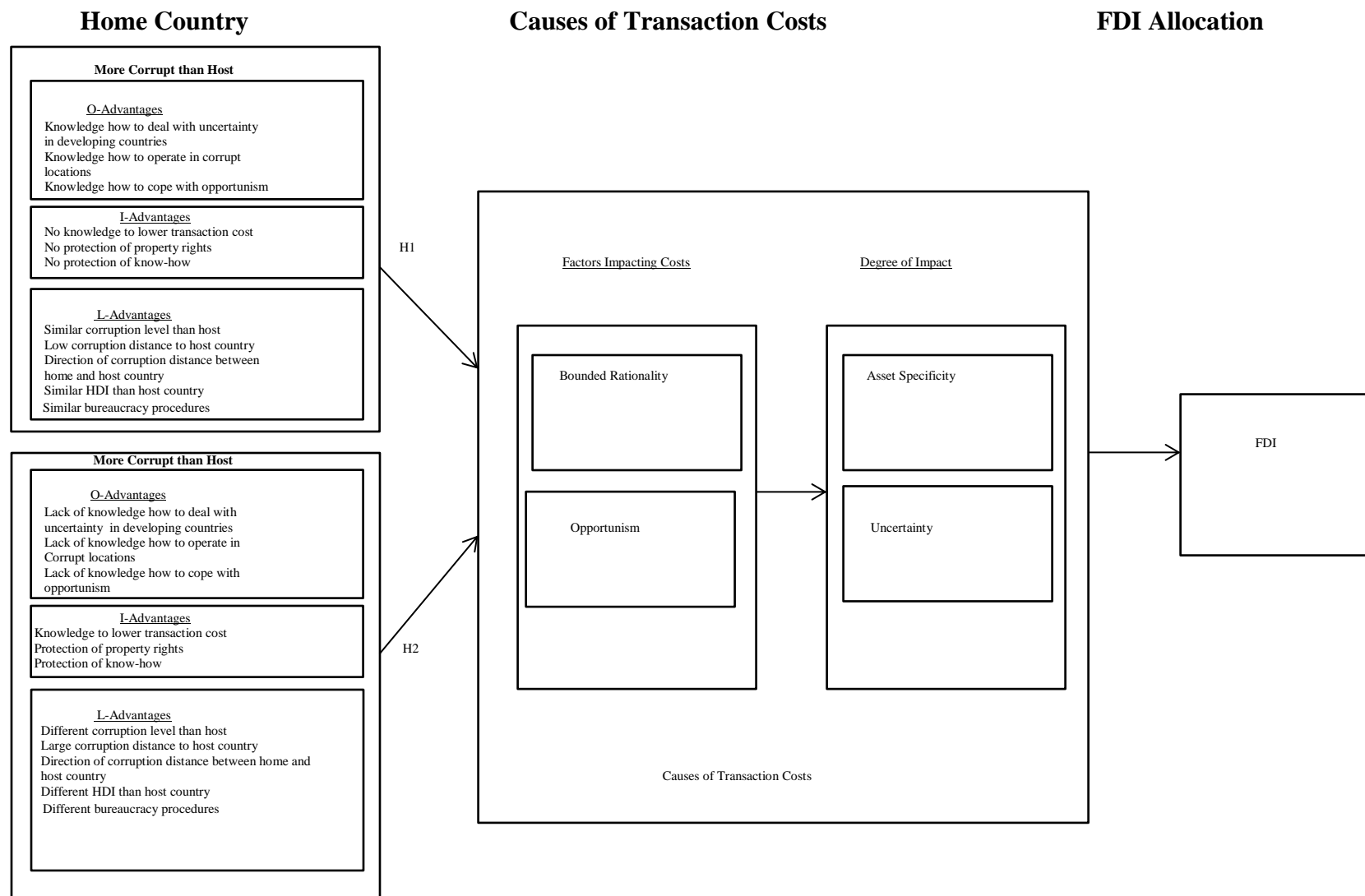
However, the degree of risk and uncertainty associated with corruption varies by different firms. It is possible that foreign investors from highly corrupt countries use their knowledge of how to deal with corruption as a competitive advantage (Cuervo-Cazurra & Genc, 2008) against those without such knowledge. Studies analysing MNEs from developing countries have found that the experience of operating in less than ideal institutional conditions can be considered to be a location-bound O-advantage (Buckley, et al., 2007). Furthermore, these O-advantages enable firms from developing countries to operate more efficiently in other developing countries (Cuervo-Cazurra & Genc, 2008). Therefore, drawing on their O-advantages certain firms might prefer to invest in foreign locations that resemble their home environment. Building on this premise, corruption can be seen as influencing L-advantages as either a deterrent or encouragement to inward FDI. Acquiring skills in managing corruption may help to develop a certain competitive advantage (Habib & Zurawicki, 2002) and thus, when they internationalise, they may not be deterred by host-country corruption, and they may take advantages of their knowledge about working with corruption government at home and be attracted by it for three reasons.

First, they may face lower costs of dealing with host country corruption than firms from developed countries, based on the causes of transaction costs. Second, they may even deliberately select countries with high levels of corruption (but lower than their own) due to the similarities in conditions with their country of origin (Cuervo-Cazurra, 2006; Buckley, et al., 2007). Third, equipped with advanced knowledge in international business and a vast international network, MNEs may have developed sophisticated skills of bribery (Kwok & Tadesse, 2006). Those firms that have developed knowledge of how to cope with corruption at home might be able to minimise the risks and costs produced by corruption abroad. The experience of firms in their home markets does not equip them to deal with host country corruption. We therefore propose:

Hypothesis 2a: Corruption distance will have no association, or a positive one, with inward FDI when the home country has higher levels of corruption than the host country



**Figure 1: Model of costs of investing in a highly corrupt host country based on the level of corruption of the home country**



## **CHAPTER THREE: OVERVIEW OF FDI FLOWS, FDI DETERMINANTS, AND CORRUPTION IN LATIN AMERICA AND GUATEMALA**

### **3.1 Introduction**

In this chapter a description of FDI flows, its determinants, and corruption in Latin America will be provided. The rationale for analysing how corruption affects the attraction of FDI to Latin America is due to the size of the region and its substantial FDI inflows, which can provide a clear macroeconomic picture of the issue. Also, all the countries in Latin America are considered developing and thus with high levels of corruption (Except Chile that does not present high levels of corruption but is still considered developing). Therefore, this region represents an ideal location to study how corruption affects FDI depending on the corruption levels of the home countries.

The second section of the chapter presents FDI flows and its determinants as well as corruption in Guatemala. The reasoning behind this decision is to analyse how corruption affects FDI at the firm-level. Also, since FDI decisions are made at the firm level it is paramount to understand how corruption affects these decisions and Guatemala presents a suitable location to conduct this analysis due to the levels of FDI that the country receives and its high levels of corruption.

### **3.2 Brief History of Foreign Direct Investment to Latin America**

The Latin American region has a long history of FDI dating back to the 19<sup>th</sup> century (Behrman, 1974). Initially FDI was mainly export-oriented, and/or natural resource seeking by MNEs from developed countries. After WWII, however, FDI to the region shifted towards manufacturing for local consumption (Biglaiser & De Rouen, 2006). Despite the attractiveness of the region, local governments had a detrimental influence on foreign businesses by exercising significant regulative powers and enforcing them randomly (Grosse, 1989). It was until the 1980s that local governments began opening the region to foreign MNEs fuelled by the need of local governments of foreign exchange (Trevino, et al., 2004).

Figure 2: Map of Latin America



Due to the prohibition of most imports and by restricting FDI to the region, many countries created an unattractive business climate to foreign MNEs. Exacerbating this problem, a shortage in foreign currency created an important crisis throughout the Latin American region. These policies led to closed economies that did not open to foreign commerce until the 1980s (Trevino, et al., 2004). Nevertheless, during the past three decades, several Latin American countries have employed market-oriented reforms hoping that such reforms would indicate their good intentions towards prospective foreign investors (Rodrik, 1996). These reforms included changes in tax laws, liberalisation of trade, privatisation, financial reform, and the removal of barriers to international capital flows (Biglaiser & De Rouen, 2006). FDI flows to the area fluctuated up and down in the 1970s and 1980s with no distinctive tendency to rise. However, the region saw an explosion of inward FDI during the 1990s. The magnitude of this capital flows to the region has been well defined in literature; nevertheless, this phenomenon is still quite unusual for any region in the world (Rivera-Batiz, 2000).

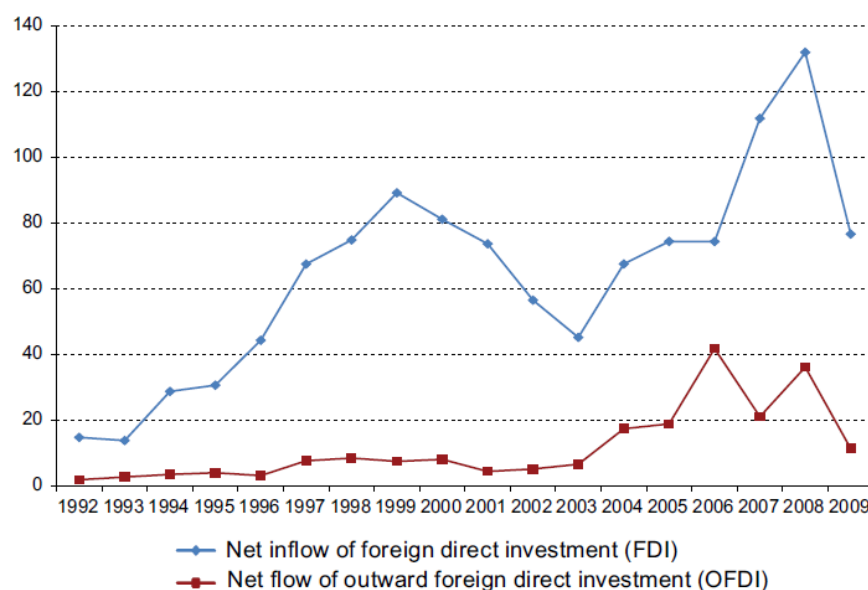
Latin America also experienced changes due to the deregulation it experienced during the 1990s. During the last decade of the last century the area underwent

several reforms that opened its doors to trade with foreign MNEs (The Economist, 2012). Furthermore, the region has also shown stability during the last five years. This stability is shown with the region's GDP growth averaging 4%, also demonstrating its endurance in the face of the global crisis of 2008 when the markets bounced back rapidly (The Economist, 2012).

### **3.3 Foreign Direct Investment Flows to Latin America**

According to the Economic Commission for Latin America and the Caribbean (ECLAC) (2010), due to the global recession, FDI flows to Latin America in 2009 reached US\$77.675 billion, which represents a 41% decline compared to an all-time high in 2008 as presented in Figure 2. In South America FDI decreased 40% to US\$54.454 billion, being Brazil, Chile, and Colombia the region's largest recipients. Mexico also felt the consequences of the global recession by receiving US\$12.522 billion, which is 47% less FDI than in 2008; however, this made Mexico the third largest recipient of FDI in the region after Brazil and Chile. Central America was also affected by the recession and FDI to the region shrank 33% compared to the previous year amounting to US\$5.05 billion. In the region, Costa Rica, Guatemala, and Panama were the largest recipients of FDI. Finally, the Caribbean also saw a decline in FDI flows by 43% to US\$5.662 billion.

Figure 3: Latin America and the Caribbean Inward and Outward FDI, 1992-2009 in billions of US\$



Source: Economic Commission for Latin America and the Caribbean (ECLAC) 2010

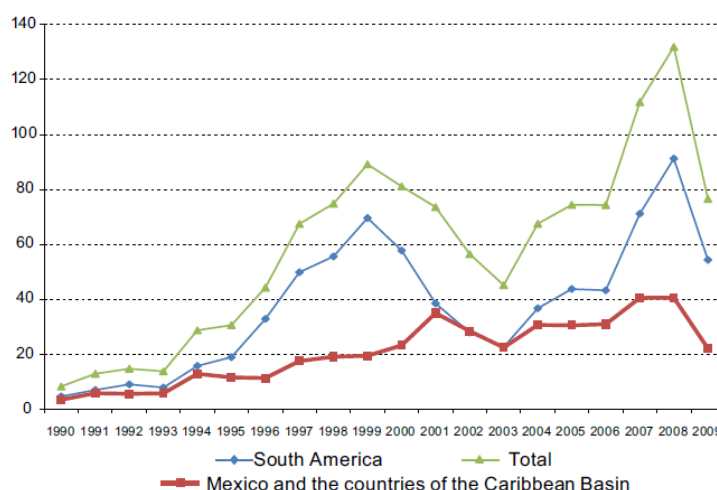
Even though FDI flows to the region decreased drastically in 2009 from the previous year, FDI levels to the region were the fifth highest in history (2010). In fact, FDI flows to the region have trended upwards during the past two decades, and the post-crisis recovery was remarkable (2012). This was achieved by steady structural characteristics of this kind of investment in the region, comprised mainly of commodities and low and medium-low technology manufacturing with investment in asset seeking investment that generate research and development (R&D) almost inexistent (ECLAC, 2010). This trend means that the region did not suffer from the global recession as badly as other regions because firms tend to cut expenses in R&D activities first when facing financial problems. However, even though the region benefited by the structure of FDI received, Latin America has a strong potential to attract more FDI to its technology sector in order to transition to more technological activities, which would strengthen the region's absorptive capacities.

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### 3.3.1 Trends and Characteristics of Inward FDI flows to Latin America and the Caribbean

The global financial crisis overturned the rising trend of inward FDI flows to the Latin American region. According to the United Nations Conference on Trade and Development (UNCTAD) (2013), even though the region saw a sharp decline in FDI inflows in 2009, the average flows were above annual averages for the decade. Furthermore, FDI received in the region were the fifth highest ever received and this is excluding the main financial centres in Latin America. This section will analyse FDI inflows into the region.

Figure 4: Latin America and the Caribbean Inward FDI by sub-region, 1992-2009 in billions of US\$

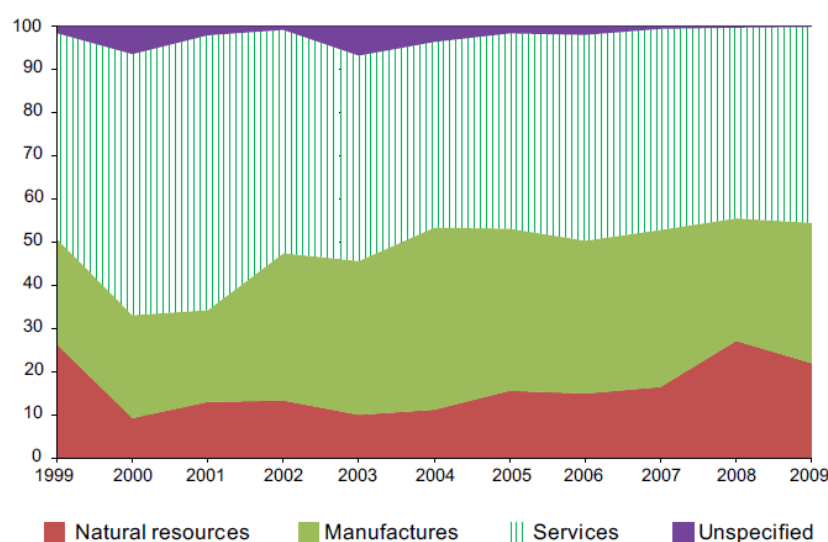


Source: Economic Commission for Latin America and the Caribbean (ECLAC) 2010

As presented in Figure 3, the decrease on FDI to Latin America is evident in every sub-region despite the different sectors and specialisations that each of these sub-regions possess. In fact, FDI inflows to South America reached US\$54.454 billion in 2009, which is 40% less than the previous year. Mexico and the Caribbean Basin

received US\$23.211 billion in the same year, seeing a decrease of 43% in FDI inflows compared to 2008 (ECLAC, 2010). The decrease in FDI to the region can be explained by (a) problems in obtaining access to credit and the high levels of uncertainty at the time; (b) the abrupt decrease in commodity prices, which caused a reduction in natural resource-seeking FDI; (c) the North American recession; and (d) the recession in many other world's countries (ECLAC, 2010). Even though FDI flows to South America dropped in 2009 all this sub-region, the sub-region has been steadily been one of the most important recipients of FDI worldwide during the past three decades. Figure 4 presents the distribution of inward FDI to Latin America from 1999 to 2009.

Figure 5: Latin America and the Caribbean: Sectoral Distribution of FDI, 1999-2009 (Percentages)

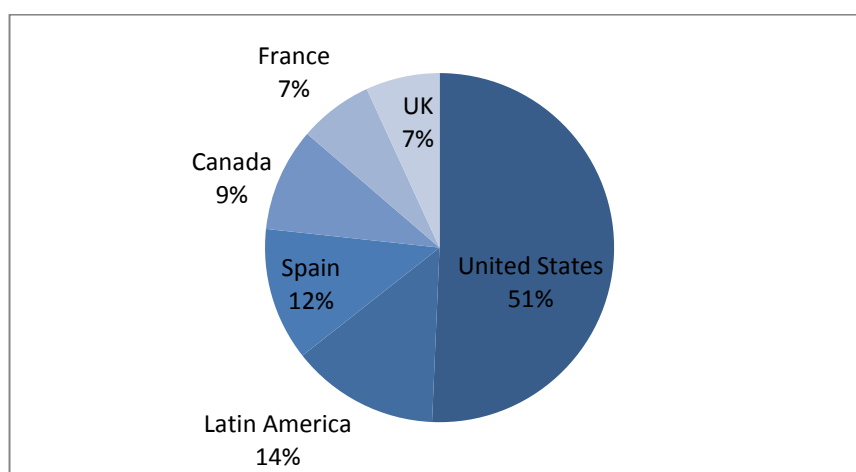


Source: Economic Commission for Latin America and the Caribbean (ECLAC) 2010

In South America, Brazil, Chile, and Colombia have been the largest recipients of FDI, even though in 2009 these countries saw a deep decline in FDI inflows. According to ECLAC (2010), South America experienced a decline of FDI inflows

compared to 2008. Also, UNCTAD (2013) says that the region receives most of its FDI in the primary and services sectors and due to the global recession, the region's economy contracted from a 5.1% growth in 2008, to a -0.2% decrease the following year. This contraction in the country's economy deterred market seeking FDI in 2009. Mexico and Central America have also been important recipients of FDI in the Latin American region. The main investor in this sub-region is the United States, and for that reason the recession that hit the North American giant also affected these Latin American countries. Nonetheless, similarly to the South American Sub-region, Central America has seen a steady increase in FDI flows in the past three decades and even though this rise was stopped in 2009, the region still receives considerable amounts of FDI especially in export platforms. Nevertheless, according to the UNCTAD (2013), the amounts of FDI received by the region are still extremely high compared to what the region has historically attracted and compared to other regions in the world. Figure 5 presents the country of origin of FDI to the region from 1998 to 2009.

Figure 6: Latin America and the Caribbean: Origin of FDI, 1998-2009



Source: Economic Commission for Latin America and the Caribbean (ECLAC) 2010



### 3.4 Determinants of FDI to Latin America

Foreign direct investment has aided in a significant manner the economic development of Latin America since the early 1990s because capital in this region is limited (Blanco, 2012). Despite some criticism literature on FDI has overwhelmingly demonstrated that FDI has positive effects on host countries (Tan & Meyer, 2011) especially in Latin America (Wooster & Diebel, 2010). Authors researching the effects of FDI in Latin America have stated that this investment helps to growth on productivity (Blonigen & Wang, 2005) and thus, might help developing countries to begin their road to development. Therefore, scholars have devoted great efforts to understanding the determinants of FDI to Latin America and a brief overview will be provided in this study.

As previously mentioned the OLI paradigm is the most known approach utilised to study cross-sectional patterns of FDI (Fatehi & Englis, 2012). In summary, the OLI paradigm argues that a firm must possess specific or impalpable advantages over other firms operating in foreign markets. Such firm can choose to maximise those benefits provided by their ownership advantages by allowing another company produce its goods or services in foreign markets via licensing. Nonetheless, a firm may desire to invest abroad with its own subsidiary, as opposed to licensing, it monitoring is difficult and transaction costs are high (Caves, 1982; Dunning, 1993). Based on this rationale, the OLI paradigm explains that the decision of investment abroad occurs before the decision of where to locate such investment (Graham & Krugman, 1995).

Along these lines, the OLI paradigm the motivations for an MNE to establish operations in a particular location through FDI depend on the L-specific advantages, or in other words, this decision depends on location-specific conditions of the host country. Consequently, the macroeconomic conditions of a location can influence FDI choices (Asiedu, 2002; Chakrabarti, 2001). Studies for the particular case of Latin America present evidence of the attractiveness of the region to receive FDI.

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Such studies, both empirical and theoretical, on FDI determinants to the region suggest that some of the economic variables determining location-specific reasons include market attractiveness, inflation rate, unemployment rate, quality of infrastructure, education levels of population (Trevino, et al., 2002; Trevino, et al., 2002; Arbelaez & Ruiz, 2013). In addition to economic determinants for FDI in the region studies have identified institutional factors such as the development index, rule of law, economic freedom, bureaucracy, and most importantly for this study, corruption (Trevino, et al., 2004; Trevino, et al., 2008; Arbelaez & Ruiz, 2013).

### **3.5 Corruption in Latin America**

Corruption is increasingly seen as one of the most significant threats that Latin America is currently facing (Selingson, 2006). In fact, Weyland (1998) says that democracies in the Latin American region are threatened by a staggering growth in corruption that has arisen since the dictators of the past left power. Weyland (1998), argues that corruption has increased under the new democratic states in Latin America due to the dispersion of power that was concentrated in the hands of a few during the dictatorships; the liberal reforms that have opened many areas of the local economies to bribery; and the prominent role that expensive TV ads play in electing candidates to public office who to perpetuate their power seek illegal forms of economic support to afford such TV exposure.

According to Selingson (2006), corruption is increasing in Latin America because the people who are in charge of controlling it are in fact benefiting from corrupt deals. In fact, in his study, Selingson (2006) finds that throughout Latin America members of the government elite, the judiciary system, and the bureaucracy are perceived to be involved in corrupt acts in the whole region. Furthermore, the author states that corruption corrodes trust and confidence in the political system of the Latin American countries he studied. However, this author did not provide an answer of whether or not corruption affected the attraction of FDI to the region and if it did how it affected this kind of investment.

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### 3.5.1 Market Attractiveness

The role of market attractiveness refers to the preconception that MNEs seek foreign markets that offer a strong potential for growth (Eaton & Tamura, 1994). According to Grosse and Trevino (1996), FDI theory proposes that FDI will go primarily to markets that are considered large enough to provide the economies of scale required for production. This statement explains why FDI goes primarily to developed countries since most FDI has been historically market seeking (Grosse & Trevino, 1996). However, when testing determinants for FDI into Latin America, Trevino et al., (2002) found that host country GDP was a significant predictor of FDI in the region. Moreover, a study conducted by UNCTAD found that market size was the main determinant of FDI into the region (UNCTAD, 1994).

### 3.5.2 Inflation Rate

The currency value of a country might be weakened by monetary policies or by economic instability. Currency devaluation might be the result of such policy variations and foreign investors should cover the costs to avoid transaction losses when the host country currencies devalue. Hence, *ceteris paribus* a stable real exchange rate is preferred by foreign investors to minimise exchange rate risks inherent to investing in a foreign location (Ciccarelli & Mojon, 2010). Furthermore, economies experiencing high rates of inflation tend to undermine sales and therefore, market-seeking MNEs would avoid a foreign location experiencing high inflation (Kahai, 2004). Also, high rates of inflation can be a signal of economic uncertainty and of the host government's lack of capacity to impose an adequate monetary policy (Arbelaez & Ruiz, 2013). Therefore, scholars have argued that high inflation might have negative effects on the attraction of FDI (Asiedu, 2002). Moreover, high inflation rates have been presented as deterrents of FDI flows to Latin America (Trevino, et al., 2004).

### 3.5.3 Unemployment Rate

Multinationals interested in establishing operations abroad should have in mind the characteristics of the local workforce they need to employ in the proposed area. However, the association between unemployment rate and FDI inflows to a region is mixed. According to Billington (1999), one of the most important variables explaining the attraction of FDI is the availability of labour. In order to test his proposition, Billington (1999) argues that the greater unemployment rate of a host location, the greater the FDI inflows since the foreign MNE can have a greater pool of possible employees. Also, the unemployment levels will make people have a higher value on their existing employment or any potential future job. On the other hand, Ray (1989), the unemployment rate in a foreign location decreases the degree of FDI. Pearson et al., (2012) also argue that high unemployment rates are related to socio-economic issues such as high crime rates that might deter FDI since MNEs may not be allured to having a lasting interest in such an environment. Despite the debate of whether or not the unemployment rate encourages or discourages FDI, its importance as an MNE determinant is rarely disputed in current literature, especially in Latin America (Tsai, 1994; Tuman & Emmert, 2004; Bengoa & Sanchez-Robles, 2003).

### 3.5.4 Quality of Infrastructure

Researchers have used the number of fixed telephone lines and mobile telephones per 1000 people in a location as a proxy for the quality of infrastructure of a country (Kahai, 2011). The rationale explained for using the number of telephones used in a location to represent the quality of infrastructure is because countries with an adequate telecommunications infrastructure usually have similar quality in other aspects such as roads, and the Internet. Infrastructure, in this sense, covers several dimensions of physical assets such as roads, sea ports, and telecommunications, to institutional ones, such as accounting and legal services (Kahai, 2011). However, the telephone proxy might not be adequate for the Latin American region.

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Instead of using the number of telephone lines per 1000 people in Guatemala this study uses an innovative method to account for infrastructure, which is the number of internet users. The rationale for taking the number of internet users as a proxy for infrastructure obeys to the fact that nowadays communications via internet are perceived as more important than traditional telephone ones (Choi, 2003). Furthermore, in Latin America the usage of internet lags most regions in the world, which might deter FDI to the region. According to Katz (2009) states that in 2008 the average internet usage in Latin America averaged only 5.5% of the population while in the industrialised world it surpassed 25%. Therefore, the number of internet users may portray a more accurate snapshot of the infrastructure quality of the Latin American region.

### **3.5.5 Education Levels**

Education is a central element of a country's institutional environment since it offers socialising practises that prepare individuals to be a part of a society (Meyer, 1977; Trevino, et al., 2008). Education is also an important aspect that central in the transmission of societal norms and beliefs from generation to generation (Turner, 1997). According to Trevino, et al., (2008), educational levels in a location have two main impacts on FDI inflows: to act as a proxy for quality labour because foreign investors should be interested in establishing operations in locations with available qualified human resources (as long as they are not too costly); and MNEs are also attracted to locations with high levels of education since their operations often need more skilled labour than the rest of the economy.

While analysing the determinants of FDI to Latin America educational attainment proved to be an important factor (Trevino, et al., 2008). Furthermore, Boresztein, et al., (1998) argues that developing countries are not attractive solely on the basis of low cost labour, but instead, they needed a minimum educational level of their human capital to attract inward FDI. In fact, Latin American countries that offer high levels of skilled labour receive larger amounts of FDI (Blanton & Blanton, 2007).  
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For example, the decision of Intel to set up a plant in Costa Rica was partially motivated by the high levels of skilled labour available in the country (Jensen, 2006).

### **3.5.6 Human Development Index**

Scholars have long argued that measuring the attractiveness of a foreign location based solely on GDP does not capture the whole picture of such place. Instead, it has been claimed that focusing solely on GDP can come at the expense of other important factors that are needed to evaluate the attractiveness of a possible investment location (Stiglitz, 2006). Therefore, studies have used the United Nations Human Development Index (HDI) to capture the value of an array of factors that have been found to attract FDI (Globerman & Shapiro, 2003). This index measures not only GDP, population, and literacy, but also life expectancy at birth, all of which have been tested to be determinants of FDI in developing countries (Globerman & Shapiro, 2003).

### **3.5.7 Rule of Law**

Besides a strong host economy, multinationals require a stable environment on which to conduct operations outside their home country. However, several developing countries lack the development of regulatory institutions that protect the interests of foreign multinationals (Meyer, 2001), which results in ambiguity of the rules to follow (Roy & Oliver, 2009) and thus, decreasing FDI inflows. Furthermore, underdeveloped institutions do not provide strong enough bases for fostering financial, organisational and technological resources that MNEs need to compete in foreign markets (Hitt, et al., 2000). Therefore, MNEs prefer to invest in those countries where their basic rights are protected by an adequate rule of law.

### **3.5.8 Economic Freedom**

Even though researchers agree that variables such as market size and educational attainment are significant determinants of FDI, the role of economic freedom has

seldom been tested. However, according to Bengoa and Sanchez-Robles (2003), the economic freedom variable is of utmost importance when researching FDI to Latin America. Furthermore, Bengoa and Sanchez-Robles (2003) found that the Economic Freedom Index is a significant predictor of FDI to Latin America. This result is based on the idea that the more economic freedom a country enjoys the better institutional framework it offers foreign investors.

### **3.5.9 Bureaucracy**

According to Globerman and Shapiro (2003), government effectiveness (the measurement of time spent dealing with red tape and bureaucracy) in a foreign location is one of the most important factors when studying FDI inflows, especially when the host country or countries is considered developing. This can be explained because the time spent dealing with bureaucratic procedures in a foreign location delays the expected utility that potential profits can provide (Baniak, et al., 2005). Therefore, Bénassy-Quéré, et al. (2007) argue that the time spent dealing with bureaucratic procedures in a foreign location has a strong negative influence on FDI flows and it might serve as an incentive to MNEs to engage in corrupt deals to circumvent such bureaucratic procedures.

## **3.6 Foreign Direct Investment Flows to Guatemala**

Guatemala, in its modern history, has been open to foreign investment since the late 19<sup>th</sup> century. FDI to Guatemala has been devoted to most economic sectors and has aided the development of the country. Nonetheless, an internal conflict that spanned for 36 years stalled foreign investment until its resolution in 1996, when Peace Accords were signed. Thereafter, relative political stability, a strong commitment to market-oriented policies, and a stable macroeconomic environment have aided an increase of FDI flows until nowadays (UNCTAD, 2011). Guatemala has seen an increase in FDI flows in the recent past. This is explained by the size of the economy, which is the largest in Central America, and a strategic location between

South America and North America. Nevertheless, the country still underperforms in attracting FDI compared to other developing countries in the Latin American region. One of the main reasons for this underperformance in Guatemala is the rampant corruption that the country has suffered since the Peace Accords were signed in 1996 (Heritage Foundation, 2013).

Figure 7: Map of Guatemala



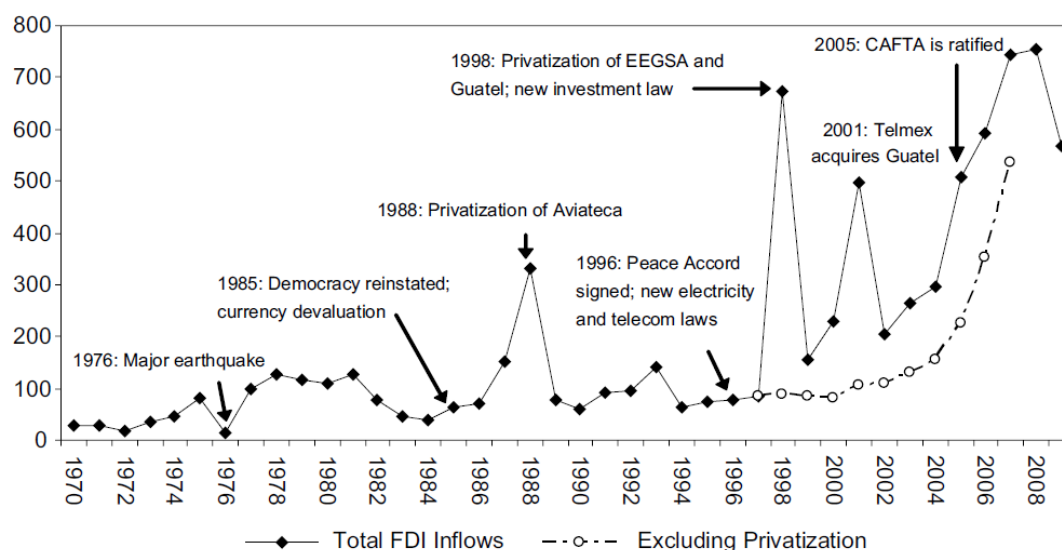
Guatemala's economy began its road to industrialisation in the 1960s when for the first time it attracted a significant amount of FDI in the manufacturing sector. This new attractiveness of the country for foreign investors was spurred due to the Industrial Promotion Law of 1959 and the creation of the American Economic Market (CACM) in 1960. As a consequence, FDI flows increased from US\$11.2 million in 1963 to US\$42.6 million in 1970. Furthermore, from 1961 to 1969 the Jose Godinez



industrial sector saw an annual growth of 8.1%, outperforming GDP growth (UNCTAD, 2011). However, the economic development happened while the country suffered political and social instability and in 1960 junior military officers lead a civil war that lasted for 36 years.

After the Peace Accords were signed in 1996 Guatemala has seen a recovery in its economy. Continual economic and political stability and modest GDP growth rates averaging 3.9% annually (compared to 4.4% for Central America), have generated an increase in FDI flows since 1997 (Figure 6) (UNCTAD, 2011). In fact, Guatemala has received the largest amounts of FDI in its history during the last decade. The privatisation of several public companies in the electricity generation and telecommunications is the main factor for this increase in foreign investment. However, other sectors have also seen an increase in foreign investment flows. Privatisations aside, FDI flows in the food and beverages, textiles, retail and mining have lead the attraction of FDI to the country (Banguat, 2012).

Figure 8: FDI flows to Guatemala from 1970 to 2009 (Millions of US Dollars)



Source: United Nations Conference on Trade and Development (UNCTAD) (2011).

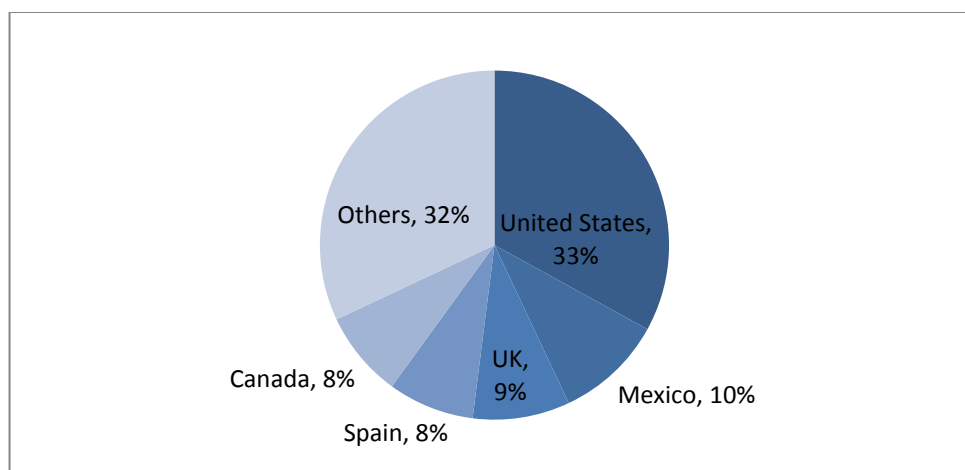
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Even though Guatemala presents clear potential for attracting higher levels of FDI inflows, several issues need to be addressed to transform investment into development. These issues include severe income inequalities since Guatemala is ranked within the top 20 countries with most unequal income distribution in the world (UNDP, 2009). High levels of crime and insecurity also undermine Guatemala's attractiveness to foreign businesses. According to the United Nations Development Programme (UNDP) (2009), both criminality levels and poverty can be traced back to the high levels of poverty of the country. Finally, According to Transparency International (2011), Guatemala's inequality, poverty, and criminality problems have the same root, corruption. Transparency International ranks Guatemala in 113<sup>th</sup> place out of 176, which means that this issue should be tackled to see an improvement in the overall economic and social performance of the country.

### **3.6.1 Trends and Characteristics of Inward FDI flows to Guatemala**

Even though the origin of FDI flows to Guatemala has diversified lately, the United States of America is still by far the largest investor in the country. According to the Guatemalan Central Bank (2012), in average 30% of FDI inflows to Guatemala comes from the United States. Companies from the United States operate in several sectors in Guatemala, from retail, agriculture, to consumer goods; American firms have operations in most major sectors of the Guatemalan economy (Figure 7). On the other hand, investment from other countries is not as diversified. Mexican FDI concentrates primarily in the food and beverages and telecommunications industries. Spanish FDI is concentrated in telecommunications and tourism while Canadian FDI goes mainly to mining.

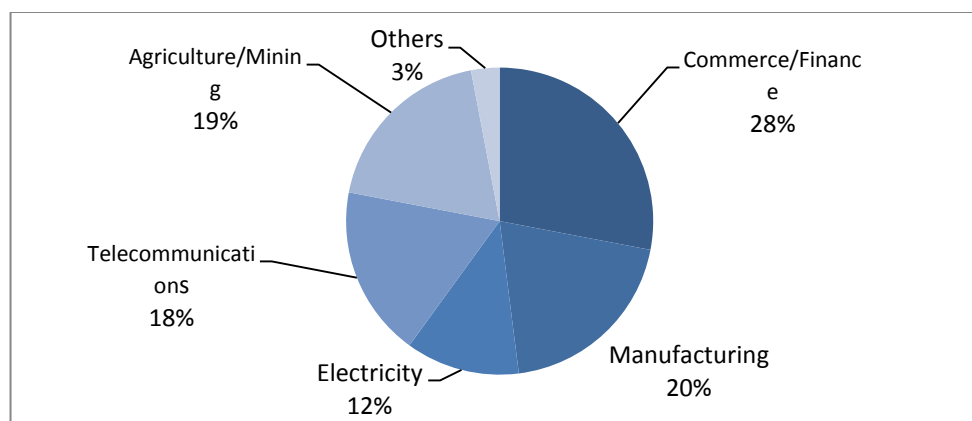
Figure 9: Guatemala: Country of Origin of FDI, 2006-2009



Source: Central Bank of Guatemala (2012)

Notwithstanding the investment received in Guatemala due to privatisation, there is a strong presence of FDI in the manufacturing, commerce and finance sectors (Figure 8). In the manufacturing sector, food and beverages is the largest component of FDI in Guatemala with 19% in the period of 2006 to 2009. During the same period the finance and commerce sector has received 29% of the total amount of FDI to the country (Banguat, 2012). However, the agricultural and mining sectors have not received large amounts of FDI mainly due to corruption in the allocation of permits (Marroquin, 2013).

Figure 10: Guatemala: Sector of FDI, 2006-2009



Source: Central Bank of Guatemala (2012)

### 3.6.2 Corruption in Guatemala

States transitioning after an internal conflict usually have very weak institutions and a rising influx of foreign investment. These two circumstances, according to Rose-Ackerman (2008), provide incentives to local officials to make corrupt deals for their personal gain. This can be explained because the conflict might have nurtured a culture of impunity and secrecy on which illegal acts are fairly easy to cover. Furthermore, the end of such conflict might not encourage the enactment of a transparent government with accountability for its actions, especially if those who benefitted financially from the conflict remain in power. Hence, even though incentives to participate in corrupt deals exist everywhere, the frequency and magnitude of corruption may be especially elevated in post-conflict countries (Rose-Ackerman, 2008), which is the case of Guatemala.

Even though Guatemala's constitution clearly states that corruption is illegal, corruption is rampant in the country (Transparency International, 2011). Moreover, even though Guatemala has held democratic elections since 1986, most political analysts argue that military and criminal powers influence all major political parties

(Peacock & Beltrán, 2003). Hence, the legislative, executive, and bureaucratic sectors of the country are believed to be influenced by the same sectors despite of which political party is in power.

Unsurprisingly, a considerable number of Guatemalans claim to not trust their politicians and central authorities in all three main areas of the government: The political elite, bureaucrats, and members of the judicial system. This has become evident in the results of a study conducted by Americas Barometer on which Guatemala was ranked as the country with third-lowest level of belief in its public institutions out of 26 countries in the Americas (Migliorisi & Prabhu, 2011). Furthermore, according to Migliorisi and Prabhu (2011), both local and foreign investors take advantage of the rampant corruption in Guatemala to advance their own interests. However, during the extensive literature review performed for this study, no literature on how corruption affected the attraction of FDI in Guatemala was found.

Although, as mentioned before, no study linking how corruption affects the attraction of FDI was found in relevant literature, the World Bank published a significant study of how widespread corruption is in Guatemala. According to the World Bank (2005), foreign and local investors in Guatemala perceive the government elite to be highly corrupt. In fact, all the respondents in this study expressed that the business climate in Guatemala is dominated by illegal payments to members of the government elite and bribes are a common practice amongst them. Nevertheless, the study did not present results of to what extent different investors perceived the Guatemalan government elite as corrupt or which investors were more affected by corruption in this segment of the Guatemalan government.

When discussing about corruption in the judiciary system in Guatemala, respondents to the World Bank's Transparency, Corruption, and Governability study also expressed high levels of corruption in this branch of the government (World Bank, 2005). According to the World Bank's study, respondents expressed that corruption

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in the judiciary system is rampant in Guatemala. The rationale for these expressions is based on the lack of independence that members of the judiciary system have in the country (even though this branch of the government should be totally independent) and how members of other branches of the government and of the private sector can influence judicial decisions.

The World Bank's report also mentions that investors in Guatemala perceived high levels of corruption in the Guatemalan bureaucratic sector (World Bank, 2005). The report says that two thirds of investors in Guatemala perceive high levels of corruption in the bureaucratic sector and that more than one third of bureaucrats reported to have witnessed corrupt acts in their organisations. Nevertheless, as mentioned before, The World Bank report does not make a difference regarding whether or not foreign investors are more or less affected by corruption in Guatemala based on the corruption levels of their home countries.

### **3.6.3 Dimensions of Corruption in Guatemala**

Reports on how corruption affects FDI in Guatemala are virtually inexistent, and the same situation is found when analysing the extent on which pervasiveness and arbitrariness of corruption affect FDI in the country. Furthermore, even though scholarly research has been performed on these two dimensions of corruption, an analysis at the firm level is needed to understand how these dimensions affect the process of allocating FDI to a foreign location.

As mentioned before, arbitrary corruption is described as the level of uncertainty created by corruption (Uhlenbruck, et al., 2006). In this sense, foreign investors might be deterred by the lack of knowledge of how to cope with corruption rather than the level of corruption itself. On the other hand, pervasive corruption is classified as the likeliness of a foreign investor to encounter corruption in a foreign location. Pervasive corruption, in this sense, pervasive corruption may affect how a foreign investor assesses the costs associated to operating in a highly corrupt foreign

location (Doh, et al., 2003). Nevertheless, according to the World Bank's Transparency, Corruption, and Governability study investors in Guatemala have a general idea of how the dimensions of corruption (World Bank, 2005). However, this study did not actually capture how the dimensions of corruption affected the investment decision-making process or if different investors were affected in a different manner.

### **3.7 Summary of the Chapter**

This chapter provided a description of FDI flows to Latin America and to Guatemala. The chapter also presented scholarly literature dealing with the determinants of FDI to the Latin American region and Guatemala as well as an account of how corruption affects the area. Latin America is an extremely important receptor of FDI; however, it also presents astonishing amounts of corruption. Therefore, understanding how corruption affects FDI flows to the region would help to combat this problem. The chapter also presents a more detailed analysis of how corruption affects a country and for this purpose, Guatemala was chosen due to its high levels of corruption and attraction of FDI from several foreign investors.

## **CHAPTER FOUR: RESEARCH METHODS**

### **4.1 Introduction**

Methodology is concerned to the manner on which a researcher approaches a problem. Research methods are the procedures and rules that can be seen as tools or means to solve problems. Research methods play a number of roles such as: the reasoning to reach a solution, explain how the solutions are going to be achieved, and the examination and evaluation of the findings of a given study (Ghauri & Grønhaug, 2005).

In order to answer the research questions: a) How does corruption distance between home and host country affect the attraction of FDI to emerging markets? And b) Why are some foreign firms less negatively affected than others by high levels of host country corruption when investing abroad? This study draws on two different approaches namely a macroeconomic and a firm level analysis. The macroeconomic analysis's purpose is to establish whether or not the distance and its sign between the corruption levels of two sets of foreign investors (investors with either higher or lower corruption levels than the host location) have an effect when investing in a highly corrupt area. The second analysis focuses on how corruption affects the attraction of FDI and operations at a highly corrupt host country location. To do so, a firm level analysis is utilised.

### **4.2 Mixed Methods to Analyse how Corruption Distance and its Effect on FDI**

#### **4.2.1 Mixed Methods Approach**

Early efforts to enrich methodological pluralism were proposed by scholars in the social sciences with quantitative backgrounds (Webb, et al., 1966). These efforts were proposed based on the validity problems deriving from a single method or concept (Byrman, 1992). This motivation resulted in several combinations of



research methodologies. However, methods triangulation is considered as the most popular methodology in business studies (Hurmerinta-Peltomäki & Nummela, 2006).

Triangulation is not the only term that has been used to describe the combination of quantitative and qualitative methods. Terms such as multi-method, methodological mix, integrated mix, multiple methods, and combined methods have been used in different studies (Tashakkori & Teddlie, 1998; Teddlie & Tashakkori, 2003). Nevertheless, the usage of these methods has been inconsistent, which has generated criticism (Erzberger & Kelle, 2003). For this reason, and to maintain consistency with mainstream IB literature, this study will use the term *mixed methods* as its research methodology. In line with Creswell et al., (2003, p. 212) this research defines mixed methods as “one that combines qualitative data collection and/or analysis with quantitative data collection and/or analysis” in a single study.

To make the definition used in this study more explicit, few points should be clarified. Hurmerinta-Peltomäki and Nummela (2006) say that there are 13 different options of mixed methods. However, for this study a mixed methodology strategy a combination of quantitative and qualitative elements in the data collection and analysis. In addition, Creswell et al., (2003) say that from a methodological point of view, four possible phases can be identified: *initiation*, before the data collection; *implementation*, when the data is collected; *integration*, when the data is analysed; and *interpretation*, when conclusions are drawn. For this section of the study, a qualitative approach in the form of interviews will be used. After the interviews were conducted, the information gathered was used to construct a questionnaire to be analysed quantitatively.

The first section of this study attempts to answer the research question: How does corruption distance between home and host country affect the attraction of FDI to emerging markets? To do so, corruption itself is not used as a deterrent or encourager of FDI. Instead, this section of the study argues that it is the *distance* between corruption levels of the host and home countries what has an impact on FDI.

Furthermore, this section of the study argues that when investing in a highly corrupt host region, those firms located in home countries with a higher corruption level than the host countries are not affected by corruption distance, since they are familiar with operating in a highly corrupt location. On the other hand, firms located in countries with lower levels of corruption than a highly corrupt host country will be affected by the distance in corruption levels between the host and home country. In order to carry this section of the research, a macroeconomic approach is needed to determine whether or not corruption distance has an impact on FDI.

The second section of the study deals with answering the research question: Why are some foreign firms less negatively affected than others by high levels of host country corruption when investing abroad? To answer the question, a firm-level analysis is performed. In this section, semi-structured interviews were used to design a questionnaire that required decision-makers to answer how their FDI allocation was affected by high levels of corruption in a foreign location. This section also analysed how corruption affected foreign operations once the decision to invest had been made.

In order to answer both questions a mixed methodology was used. The first section of the study utilised quantitative methods to answer the *how* question, while the *why* question needed a mixture of quantitative and qualitative methods.

### **4.3 Quantitative Research Paradigm**

As mentioned, the macroeconomic section and part of the second section of this research utilises quantitative methods, which rely on numbers. This kind of research is a well-established method in social research, especially when utilised to provide a logical structure to problems to which researchers address with the help of existing theory (Fielding, 2007). A numbers-based research area, quantitative research statistically measures several business indices and has the advantage of being projectable to a larger population. The strength of this type of research lays in its

ability to analyse large amounts of data and to translate such data into easily quantifiable graphs and charts (Byrman, 1992).

### **4.3.1 Nature of the Quantitative Paradigm**

According to Sale et al., (2002), the quantitative paradigm is based in positivism. This assertion is based on the fact that science is defined by empirical research and all phenomena can be condensed to empirical indicators that represent the truth. The positivism paradigm is based on the ideas proposed by French philosopher August Comte who argued that observation and reason are the means of understanding human behaviour (Dash, 2005). According to Comte, true knowledge is developed by the experience of the senses and can be obtained by experimenting and observations (Dash, 2005). However, positivism cannot be fully applied in this research since the decision to allocate FDI rely

### **4.4 Qualitative Research Paradigm**

The second section of this research also relies on interviews, which is part of the qualitative paradigm. Qualitative paradigm argues that all quantification is limited in nature and therefore only a small portion of any reality can be seen in a quantitative manner and thus, losing important aspects of the whole phenomenon. The aim of this section of the study is to understand how corruption affects the attraction of FDI to a highly corrupt location. Therefore, answering whether or not foreign investors based in countries with higher or lower levels of corruption than the host country are affected by high corruption in the host country is only one part of the answer and to understand *why* they are affected is imperative. Therefore, to provide a more holistic picture of the issue a qualitative analysis that provides a contextual answer based on the realist strand is needed.

#### **4.4.1 Nature of the Qualitative Paradigm**

The aim of the second section of this study is to understand how corruption affects the attraction of FDI to a highly corrupt host location at the firm level in a qualitative manner. At the core of the qualitative paradigm lies the assumption that the best approach to understand a phenomenon is to study its context (Krauss, 2005). To do so, knowledge will be created from the responses by foreign investors about how high corruption in the host country affects their decision-making process of allocating FDI. Therefore, this part of the study aims to understand the reality that the participants construct. Furthermore, the research question cannot be fully answered by only observing the interaction of decision-makers with their environment, but by making reference to the meaning that such interactions represent to the individual participants and the effects on their decisions. Since the goal of this part of the study is to understand the subjective motives on individual decision-maker behaviour, the realist strand is more appropriate to answer the research question at a firm level.

#### **4.5 Integrating the Quantitative and Qualitative Paradigms**

The quantitative and qualitative paradigms are two different stances that help researchers study different phenomena. However, the two approaches can be combined because they have the same goal of understanding the world in which we live (Haase & Myers, 1988). Furthermore, King, et al., (1994) state that both the qualitative and quantitative research share the same logic, and that the same rules of inference apply to both. However, detractors argue that the two paradigms study different aspects of certain phenomena and therefore cannot be used to validate one another (Sale, et al., 2002). For that reason, this study utilises both paradigms to complement the answers of how corruption affects FDI, instead of using each paradigm to authenticate the other paradigm's results.

### **4.5.1 Ontology**

The aim of the study is to understand the reality on which firms investing abroad are affected by high levels of corruption in the host country. Even though perceptions and interpretations are different they might be shared if they are grounded on a common experience (Maxwell, 2012). Furthermore, this research assumes the existence of elements of the social world that exists regardless of the current state of knowledge regarding corruption and its effect on FDI. This can be interpreted as realism. Realism claims that reality exists in its own and that contributes to the respondents' denotation of their environment. Furthermore, the realist strand searches the effects or limitations on individual choices by wider social forces or structures, which will be used in this study based on the limitations on the respondents' answers on how corruption affected their rationale to invest in a highly corrupt foreign location.

### **4.5.2 Epistemology**

Philosophically speaking, there are several different views and approaches to realism (Hunt, 2003). However, for this section of the study a critical realism approach will be used. One of the most potent arguments in favour of the critical realism approach is that it is performative and thus uses casual language and actions to describe a reality (Easton, 2010). The critical realist approach argues that we know the world by means of language; however, language does not define the totality of the world (Mutch, 1999). This echoes the need of this research to analyse how corruption in the host country affects managers' decision-making process, but also their current practices regarding this issue in a foreign location.

## **4.6 Macroeconomic Analysis of how Corruption affects FDI to Latin America**

Corruption is rooted in Latin America and it has a deep effect on the region (Ferro, 2004). According to Raul Ferro, director of America Economia, the deficit, protectionism, and discouragement of the free market in the region is because there

are sectors taking advantage of those conditions. Furthermore, it has been asserted that corruption is the root of all problems in the region (Salvia, 2003).

In this study, corruption distance and how it affects the attraction of FDI in Latin American countries will be analysed. To do so, home countries will be divided into countries with higher or lower corruption levels than the host countries. Also, in order to obtain a better picture of corruption and its effects on FDI the distance in the levels of corruption of host and home countries will be considered.

To test the two hypotheses, FDI inflows to 12 Latin American countries will be analysed from 2006 to 2009<sup>1</sup>: Argentina, Brazil, Chile, Colombia, Costa Rica, Ecuador, Guatemala, Honduras, Mexico, Nicaragua, Panama, and Peru. Although the number of host countries is limited, the result can provide a clear picture of how corruption distance affects inward FDI to Latin America.

Home countries are defined as either more or less corrupt than host countries. By doing so, we can also observe how FDI is affected by a region that comprises only developing countries characterised by high levels of corruption, according to Transparency International (Transparency International, 2010). The effects of corruption can be studied according to whether or not foreign investors are familiar to dealing with corruption in their home countries. Also, we can test if the distance between corruption levels affects countries with high corruption levels as well as those with lower corruption levels at home.

#### **4.7 Variables and Measurements**

In order to test the hypotheses, FDI inflows to Latin America from 2006 to 2009 were used as the dependent variable. These flows were obtained from the Economic Commission for Latin America and the Caribbean (ECLAC) publication in 2010 (ECLAC, 2010). A dichotomous variable was used as the main independent variable. This variable indicates whether the home country is more or less corrupt than the

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<sup>1</sup> These countries have been selected due to the availability of data in the years mentioned.

host country in the period of 2006 to 2009. To measure corruption the Corruption Perception Index (CPI) from Transparency International was used. This index has been widely used by scholars studying corruption and its effects (Judge, et al., 2011). The CPI rates countries from around the world from 0 (highly corrupt) to 10 (clean); however, in the model highly corrupt countries were denoted with a 10 index and clean countries with a 0 in order to obtain positive results.

#### **4.7.1 Main Variables**

##### **4.7.2 Corruption Distance**

Firstly this study begins with corruption distance when home countries are either more or less corrupt than the host countries. The distance between the host country and the home country according to the Corruption Perception Index from Transparency International was used. One important point that needs emphasis is that by analysing corruption distance, this study controls to a large extent for cultural distance, since such distance can be treated as cultural distance (Demirbag, et al., 2007). Furthermore, this measurement is more appropriate for this research since Latin America is a fairly homogeneous host region in terms of national culture as our unit of analysis (Hongxin, et al., 2004).

Based on the literature on corruption and FDI and how there is no agreement as of whether or not FDI is deterred by corruption this study argues that it is the distance of corruption levels between home and host countries what affects FDI. Moreover, this study argues that MNEs from home countries with lower levels of corruption than a highly corrupt host country may be negatively affected by the distance in corruption levels between them. On the other hand, MNEs from home countries with higher levels of corruption than an already highly corrupt host country may not be affected by the distance of corruption levels. This claim is grounded on the idea that MNEs from different institutional environments might acquire a different array of skills and know-how to be able to succeed in such environment (Jackson & Deeg,

2008). Nevertheless, this study extends this idea by also arguing that these skills and know-how can be transferred and exploited in foreign locations with similar institutional environments even if such environments are not seen as ‘ideal’ by some foreign investors.

One problem with the argument that assumes that MNEs from countries with low levels of corruption do not have the capabilities of learning how to deal with corruption abroad is that it assumes that such MNEs have a *passive* role in the issue. In other words, the problem with this argument is that it says that MNEs would have to adjust to a host institutional environment to attain corporate success. Nevertheless, there is evidence that MNEs are capable of influencing the host country institutional environment (Kwok & Tadesse, 2006). Therefore, the claim that corruption distance will have a stronger effect when the home country has lower levels of corruption than a highly corrupt host country could also be explained by the decision of MNEs of not partaking in corrupt deals abroad. In either case, however, it is expected that the corruption distance between host and home countries have a deterrent effect when MNEs from less corrupt countries invest in a highly corrupt country due to the costs that they would incur to adapt to these unknown foreign institutional environments.

### **4.7.3 Control Variables**

Although there is an ongoing debate regarding which institutions matter in relation to the attraction of FDI (Buckley, et al., 2007; Judge, et al., 2011), there are various institutional and macro-economic variables that have been used in several studies covering all three pillars of the institutional environment. These variables are constructs of several measures and sources, and hence, provide a more comprehensive measurement than individual indicators. However, they present the disadvantage of being estimates and thus could introduce measurement errors (Globerman & Shapiro, 2003). Such variables have been widely used in research analysing corruption and its effects on FDI, and encompass both institutional and



transaction cost variables. These variables are integrated in this model to observe their interaction with the corruption level of the host country. A concise description of these variables is presented next.

As control variables the human development index published by the United Nations (2012) was used. This index is a construct made up of GDP per capita, education, and life expectancy at birth, as proposed by Globerman and Shapiro (2003). The rule of law index retrieved from the World Bank Dataset (2011) measures law enforcement, property rights, crime, etc. (Globerman & Shapiro, 2003). Bureaucracy level ranks countries as how easy it is to start a business there (World Bank, 2011). The infrastructure index was taken from the percentage of internet users of the host country (World Bank, 2011). The educational attainment index was measured by the total number of college students enrolled in tertiary education (ECLAC, 2010). The economic freedom index was used to measure trade, fiscal, and monetary policy (Heritage Foundation, 2012). The inflation rate was measured as the annual percentage rate in the consumer price index from the International Monetary Fund (IMF, 2011).

The natural logarithm of the total GDP (World Bank, 2011) of the host country was used to measure purchasing power of the host country, as used by Globerman and Shapiro (2003) and Buckley et al. (2007). Finally, the unemployment rate of the host country was used to indicate the attractiveness of the country since investors are aware that employees will be loyal since their chances of finding another employment are slim (Coughlin, et al., 1991). The unemployment rate was taken from The (United Nations, 2011).

Table 5: List of the variables, their measurements, and date sources

	Variable	Theoretic Justification	Measure	Source
Dependent Variable	Ln FDI Flows		Inward FDI Flows in the Country in US\$, measured as natural logarithm	ECLAC 2010
Independent Variables	Corruption	Informal Institutions	From 10 = highly corrupt to 0 = clean	Transparency International 2011
	Corruption Distance 1	Informal Institutions	Value of the average corruption level between the home and host country for host countries with lower levels of corruption than home countries	Transparency International 2011
	Corruption Distance 2	Informal Institutions	Value of the average corruption level between the home and host country for host countries with higher levels of corruption than home countries	Transparency International 2011
	Human Development Index	Formal Institutions	Combination of three measurements, GDP per capita, education, and life expectancy. From 0 (not existent) to 100 (excellent)	United Nations Development Programme 2012
Control Variables	Rule of Law Index	Formal Institutions	Measures quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence. From 0 (not existent) to 100 (excellent)	World Bank Governance Datasets 2012

Bureaucracy	Formal Institutions	Rank of countries based on the average time to start a business	World Bank Governance Datasets 2012
Infrastructure Quality	Efficiency-Seeking FDI	Urban Development Index Based on the percentage of people using the internet	World Bank Governance Datasets 2012
Economic Freedom Index	Market-Seeking FDI	Includes fiscal, trade, and monetary policy. From 0 (not existent) to 100 (excellent)	Heritage Foundation 2012
Educational Attainment	Asset-Seeking FDI	Total college-age students enrolled in tertiary education	ECLAC 2010
Host Country Inflation	Transaction Cost	Annual percentage change in the consumer price index	IMF's annual Balance of Payments 2012
Host Country GDP	Market-Seeking FDI	Natural logarithm of a country's GDP	United Nations Statistical Yearbook 2012
Unemployment Rate	Asset-Seeking FDI	Percentage of working-age population without employment	United Nations Statistical Yearbook 2012

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Source: Author's research

## 4.8 The Model

### 4.8.1 Pearson's Correlation

The first step needed to analyse panel data is whether or not a correlation between variables is present (Crompton & Duray, 1985). To correlate a Pearson's Correlation Coefficient three different sums of squares (SS) are usually needed. This coefficient also requires the sums of squares for variable X, the sum of squares for variable Y, and the sum of the cross-products of XY (Gravetter & Wallnau, 2009). Then the sum of squares for variable X is:

(1)

$$SS_{XX} = \sum (x_i - \bar{x})^2$$

This formula keeps track of the spread of variable X. Since this formula is the numerator of the variance of X ( $S^2_x$ ), it can also be expressed as  $SS_{xx} = (S^2_x)(n - 1)$  (Gravetter & Wallnau, 2009). On the other hand, the sum of squares for variable Y is:

(2)

$$SS_{YY} = \sum (y_i - \bar{y})^2$$

As with formula (1), formula (2) keeps track of the spread of variable Y. Also, since the numerator of the variance Y ( $S^2_y$ ), it can also be expressed as  $SS_{yy} = (S^2_y) (n - 1)$  (Gravetter & Wallnau, 2009).

Finally, the sum of the cross product of formula (1) and (2) is:

(3)

$$SS_{XY} = \sum (x_i - \bar{x})(y_i - \bar{y})$$

Formula (3) is analogous to the other sums of squares except that it is used to quantify the extent to which the two variables are correlated (Gravetter & Wallnau, 2009). Therefore the correlation coefficient (r) is:

(4)

$$r = \frac{SS_{XY}}{\sqrt{(SS_{XX})(SS_{YY})}}$$

#### 4.8.2 Panel Data Analysis

Early empirical studies on corruption and its effects on FDI used ordinary least squares regressions (OLS) to estimate pooled cross-sectional data (Mauro, 1998;

Habib & Zurawicki, 2002). However, OLS treated data as if there was one single index. The model is as follows:

(5)

$$y_{it} = \alpha + \beta x_{it} + \varepsilon_{it}$$

However, the model presented by equation (1) does not depict any possible differences in individual characteristics or any particular common time series effects. However, corruption has its roots on cultural and institutional grounds and therefore it is expected that different societies have different cultural and institutional characteristics. For this reason, treating cross-country data as homogenous will results in bias caused by unobserved heterogeneity (Chen, 2008). Most recently, however, empirical studies have employed panel data methods to evade this kind of unobserved heterogeneity bias (Egger & Winner, 2005).

An alternative to avoid the unobserved heterogeneity bias in equation (1) is to assume that the model has an intercept term  $\alpha$  that is different for different countries. The model can then be written as:

(6)

$$y_{it} = \alpha_i + \beta x_{it} + \varepsilon_{it}$$

The “unobserved heterogeneity” is captured by the varying constant term  $\alpha_i$  across countries.

The panel data model presented in equation (2) encapsulates the differences in individual countries, and the estimation methods concentrate on using the available information about differences in their behaviour. After that, the task in this empirical work is to identify the nature of heterogeneity and to specify the model based on existing statistical tests (Baltagi, 2005). The model can then be estimated and inferences can be made thereafter.

In this study the panel data set contains information regarding a time dimension  $t$  ( $t = 1, 2, \dots, T$ ) and a unit dimension  $i$  which denotes a host country ( $i = 1, 2, \dots, n$ ). The model also has  $K$  variables or regressors. The model also assumes that the intercept changes for individuals but it is constant over time and the slope is constant for host countries and over time:

(7)

$$Y_{it} = \alpha_i + \sum_{k=1}^K \beta_k X_{kit} + \varepsilon_{it}$$

To estimate the model the following assumptions are made about the intercept:

(8)

$$\alpha_i = \tau + v_i$$

This means that the intercept for all the countries has a constant portion ( $\tau$ ) and a portion that changes for every country ( $v_i$ ). Based on equation (4) two models can be discussed: Fixed Effects and Random Effects. In a fixed effects model,  $v_i$  is a fixed parameter and it assumes that  $X_{kit}$  and  $v_i$  are correlated. On the other hand, in a

random effects model,  $v_i$  is a random variable and it assumes that  $X_{kit}$  and  $v_i$  are uncorrelated. In this sense, the fixed effects model can be estimated by least squares dummy variable (LSDV) regression, the within effect model, and the between effect model. The random effects model, on the other hand, is estimated by the generalised least squares (GLS) and the feasible generalisation least squares (FGLS). When the variance structure is known, GLS is used. If unknown, however, FGLS should be used (Greene, 2002).

#### 4.8.3 Empirical Model

Given the panel structure of the data in this study, the model to investigate the effects of corruption distance on FDI inflows to Latin America was constructed for a balanced panel data of 12 Latin American countries. This approach was selected in order to account for unobserved heterogeneity in the sample data. For the empirical research the following regression model was used:

(9)

$$Y_{it} = \alpha_i + \beta X_{it} + \mu_{it} + \varepsilon_{it}$$

Based on the simple form of formula (5) the following model was produced:

(10)

$$\begin{aligned} \text{LnFDI} = & \alpha_i + \beta_1 \text{CPI}_{it} + \beta_2 \text{CorrDummy}_{it} + \beta_3 \text{CorrDis1}_{it} + \beta_4 \text{CorrDis2}_{it} + \beta_5 \text{Human}_{it} \\ & + \beta_6 \text{Law}_{it} + \beta_7 \text{Bureaucracy}_{it} + \beta_8 \text{EcFreedom}_{it} + \beta_9 \text{Education}_{it} \\ & + \beta_{10} \text{Inflation}_{it} + \beta_{11} \text{Infrastructure}_{it} + \beta_{12} \text{GDP}_{it} \\ & + \beta_{13} \text{Unemployment}_{it} + \mu_{it} + \varepsilon_{it} \end{aligned}$$

In equation (6)  $i$  is the country subscript,  $t$  is the time subscript,  $\beta$ s are unknown parameters to be estimated,  $\alpha$  is the average natural logarithm of FDI for the entire



region,  $\mu$  is the between-entity error, and  $\varepsilon$  is the within-entity error. Random effects logistic regressions were used to control for the possible correlations between variables. The model was also chosen by performing a Hausman test for random effects with a  $\chi^2(01) = 1.000$ <sup>2</sup>. In addition, the model allows for a comprehensive inclusion of all the variables to reduce omitted variable bias. It also has the advantage of being replicable with little or no changes to test different geographic areas to see if corruption affects the attraction of FDI differently in different locations.

#### **4.9 Firm-Level Analysis of how Corruption affects the Attraction of FDI**

Even though the macroeconomic analysis clearly shows that corruption distance and its sign have an effect on FDI, this is only one part of the answer about how corruption affects FDI. Therefore, in order to understand why some firms are more or less affected by corruption of the host country micro-level analysis is needed. The reasoning for undertaking this approach is because FDI is carried out by firms, and hence, understanding their rationale regarding FDI allocation to a highly corrupt location is needed to have a better understanding about how corruption affects FDI.

##### **4.9.1 Research Design and Data Collection**

##### **4.9.2 Interviews**

As previously mentioned, this section of the study seeks to analyse how corruption distance affects the attraction of FDI to Latin America. In order to carry out this research an econometric approach was used to verify if home countries more corrupt than an already corrupt country react differently to high corruption in the host country than home countries with lower rates of corruption than the host country. However, according to Parkhe (2004), in various areas of rigorous empirical investigation in International Business there is no satisfactory approach to substitute interviews. However, the researcher must be cautious when conducting interviews

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<sup>2</sup> See appendix for Hausman Test

since problems can arise. According to Parkhe (2004), there are several possible problems with conducting research interviews. Such problems range from self-reporting bias, language reporting context and interpretation and so on. Nevertheless, if the appropriate safeguards are implemented research interviews to decision makers will enrich insights of most studies (Parkhe, 2004).

Daniels and Cannice (2004) argue that before deciding to conduct interviews to study an issue in International Business three requirements must be met: (1) the study must be exploratory, (2) there is a small population of possible respondents, and (3) the interviews should allow a more in-depth interaction with respondents than the interaction provided by questionnaires. In order to analyse how corruption affected the attraction of FDI in Guatemala, all three requirements were met.

Firstly, the study was exploratory in nature. Despite the fact that there is a vast literature on how corruption affects FDI, most of these studies utilised aggregated macro-economic data that was evaluated with the aid of econometric techniques. However, this issue deserves a more in-depth analysis in order to discover possible relationships or situations not previously considered. Secondly, due to the nature of the study, the number of possible respondents is reduced. This situation was magnified by the fact that issues of corruption are considered sensible and therefore possible respondents might not agree to take part of the study. Thirdly, when studying how corruption affected a firm's strategy, it is important to be able to interact with the respondent in order to understand why certain situations deserved more attention than others.

Harrell and Bradley (2009) define interviews as the discussions that occur usually one-on-one between a subject and an interviewer, intended to gather information on a specific set of topics. The rationale for choosing interviews as part of the research methods is due to the insights that these instruments offer to interpret the results from the quantitative analysis. The objective for using interviews in this study was to gather primary data to collect information about the motives of managers of

companies investing in a highly corrupt foreign location and how to cope with such corruption once operations have been established. Furthermore, in order to offer the respondents enough freedom to express their views semi-structured interviews were utilised.

The usage of unstructured interviews allowed the interviewer to have a clear plan but with minimum control of how the respondent answered. In fact, this kind of interview was ideal for the interviewee to have freedom to express how corruption affected his or her decision to invest in Guatemala and how the corruption levels of the host country affected their strategy and operations in the country. One drawback from using this kind of interview, however, is that even though this method provides a great deal of rich data, it can take a long time to collect. Therefore, according to Harrell and Bradley (2009) this kind of data collection method is most suitable when the researched has a great deal of time to spend with the interviewees.

Another aspect to take into account in this particular study is the sensitivity of asking decision-makers their personal views on corruption and whether or not they participate in it. However, the task becomes even more challenging when such decision-makers are considered members of corporate elite. According to Marschan-Piekkari and Welch (2004), corporate elites are formed by top management, specialists, and middle managers that have elite positions within a firm. This definition also includes employees with long tenure within the firm that have a broad internal knowledge of the organisation and that possess extensive internal and external networks or functional responsibility (Welch, et al., 2002).

Researchers have long acknowledged that interviewing 'elites' is a complicated task (Harvey, 2011) and as mentioned before, the complications are magnified by the sensibility of the issue of corruption. The main reasons for the difficulty in conducting elite interviews are, according to Welch, et al., (2002), (1) gaining access to elites, (2) successfully managing the power asymmetry between interviewee and interviewer, and (3) measuring the openness of elites.

In this study gaining access to managers of MNEs investing in Guatemala proved to be extremely challenging. These difficulties are acknowledged in current International Business literature since according to Welch, et al., (2002) obtaining access to elite interviewees presents different challenges to those faced when studying non-elites. Notwithstanding the difficulties inherent to access top managers of MNEs investing in Guatemala, the task proven even more difficult when the only respondents suited to be interviewed were those managers who (a) had the power to make decisions regarding the allocation of FDI; and (b) were willing to share their views on how corruption in the host country affected their decision to invest in Guatemala and their subsequent operations. Therefore, the number of interviews used in this study is only 12. However, the data gathered was rich enough to understand how corruption affected the decision making process of investing in a country with high levels of corruption and to develop a questionnaire to be administered to possible respondents.

Qualitative research relies on a successful working relation between interviewers and interviewees. However, an effective working relation can be difficult to achieve if there is a power imbalance between the interviewer and an interviewee (Kvale, 1996). Mainstream literature assumes that whenever such power imbalance occurs it is the interviewer who possesses a higher status or at least more experience in participating in complex debates. (Taylor & Bogdan, 1998) Therefore, in this sense the interviewer has a more powerful position during an interview. Nonetheless, this was not the case when interviewing managers of MNEs investing in Guatemala. In order to balance the power relationship between the interviewer and interviewees, semi structured interviews were used and thus allowing interviewees to talk about corruption without a rigid structure on the questions.

The issue of openness is an area of dispute in literature, especially the degree of openness that researchers can expect from elites during interviews (Kezar, 2003). Additionally, even though the issue of openness is paramount when conducting any

interview, the issue becomes more crucial when interviewing elites since they have more experience in handling questions and they stick more closely to organisational policies (Thomas, 1993). Nevertheless, surprisingly in this study all the participants were extremely open with their answers of how corruption affected their decision of investing in a highly corrupt foreign location, and how corruption in the host country affected their already established operations.

#### **4.9.3 Interview Design**

Before conducting interviews a goal must be set and develop questions that aid to achieve such goal. Then, the researcher must identify possible respondents, persuade those respondents to participate in the study, arrange logistics for the interviews, and finally conduct the interviews (Mason, 1996). In this study the goal was to understand how corruption affected the allocation of FDI in Guatemala and how corruption affected subsequent operations in the country. The questions were designed mirroring key issues highlighted in the existing literature. The possible respondents for this study were managers with FDI allocation responsibilities of MNEs operating in Guatemala and were persuaded due to their willingness to cooperate in the fight of corruption in the country. The logistics for conducting the interviews were planned in order to cause minimum disruption to the respondents, and finally the interviews were conducted.

This study utilised semi-structured interviews since it allows the respondent the time and scope to talk about how high corruption in the host country affected his or her decision of investment and subsequent operations. Also, the reason for the interview was to understand the respondent's point of view regarding corruption rather than making generalisations about the topic. In this sense, the interviews were more a conversation about corruption and how it affected their rationale to invest in Guatemala and their operations after the decision to invest was made. Therefore, questions such as the respondent's point of view regarding corruption, their strategy

to minimise its effects, and whether or not corruption was a deterrent to investment in Guatemala were asked when the interviewer thought appropriate<sup>3</sup>.

#### **4.9.4 Interview Administration**

In total, twelve interviews were conducted from August to November 2012. Interviewees were selected based on the following criterion: (a) Respondents should be managers of MNEs operating in Guatemala, and (b) The respondents should have direct involvement on foreign investment decisions in their companies. Respondents interviewed were divided in those whose firms were located in countries with lower corruption levels than Guatemala and those located in countries with higher corruption levels based on the CPI (Transparency International, 2010). Also, in order to have a balanced mix of respondents, half of them were managers of MNEs located in countries with lower corruption levels than Guatemala whereas the other half were managers from MNEs located in countries with higher corruption levels than the host country.

In this research all the interviews were administered with the help of Voice over Internet Protocol (VoIP)<sup>4</sup>. The choice of VoIP to administer the interviews responded to the difficulty in reaching the sites where the interviewees were located (Mexico, El Salvador, Nicaragua, United States, Canada, and Honduras). Furthermore, since all the participants hold key strategic positions in their companies, making arrangements to visit them all during the same timeframe proved extremely difficult. According to Rowley (2012), VoIP interviews save the researcher travel time and may even decrease interviewer bias, but some of the connection between the two parties might be lost.

Although the limitations inherent to face-to-face personal interviews might be magnified by conducting them via VoIP, this research minimises such limitations by

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<sup>3</sup> A copy of the semi-structured interview can be found in the appendix.

<sup>4</sup> The software used was Skype and FaceTime

not relying solely on interviews. In this section, the personal interviews are a tool to understand how managers react to high levels of corruption in foreign markets, and to construct a questionnaire to revise the issue in more depth.

#### **4.9.5 Language**

The language in which interviews are conducted is an important methodological issue that goes beyond a personal preference to an instinctive consideration of power that has an effect on the dynamics of the interview situation (Marschan-Piekkari & Reis, 2004). In fact, Marschan-Piekkari and Reis (2004) argue that when the interviewer and interviewee do not share a common native language the language on which the interview is conducted should benefit the research participant. Based on this premise the interviews were conducted in either Spanish or English. Out of the twelve participants in this study three were English native speakers and they chose English as the language for the interviews. On the other hand, the remaining nine participants, although fluent in English, decided to be interviewed in their native Spanish.

Even though the researcher was comfortable conducting interviews in both languages, it is important to acknowledge that interviewing in one language and reporting in another is a challenge that has been recognised in literature (Welch, et al., 2002). In this study, due to the nature of the topic the researcher decided to not provide transcripts to a third party to ensure that its translations into English were accurate. However, to guarantee that the translation from Spanish into English was as accurate as possible, the English transcripts were translated into Spanish and then back into English. Later, the two English documents were compared to confirm consistency.

#### 4.9.6 Quantitative Approach

#### 4.9.7 Questionnaires

Questionnaires are the most commonly used type of quantitative methods in the IB discipline accounting for 60.34% of the empirical articles published in major IB journals from 1992 to 2003 (Zhilin, et al., 2006). Furthermore, self-administered questionnaires are the most commonly utilised data gathering method in the social sciences (Blaikie, 2010). This method is preferred over surveys because questionnaires allow self-administration, a defined structure, and no intervention from the researcher except in the designing of the instrument is needed. Whereas surveys need direct participation of the researcher in filling the survey and making notes of the interaction with the subject being researched. (Blaikie, 2010). Questionnaires also allow the researcher to gather large amounts of data from a relative large sample (Malhotra, et al., 1996).

Even though the interviews conducted were of high value to answer how corruption affected the attraction of FDI in Guatemala, the reality is that they were not enough to make a generalisation of the issue. For that reason, the insights provided by the interviews were utilised to craft a questionnaire that could reach a larger sample. According to Neelankavil (2007), questionnaires are defined as a technique for collecting large amounts of data from a fairly large set of possible respondents utilising a question and answer format. However, designing a questionnaire is not an easy task. In fact, Neelankavil (2007) says that even though much progress has been made in questionnaire design it is still considered an art since very few theories in the designing of questionnaires have been developed. Despite the challenges associated to designing research questionnaires, Neelankavil (2007) provides a guideline to develop questionnaires to ensure their reliability. Firstly, questionnaires should reflect the researcher's objectives. Also, the questions and types of questions in should ethically address each topic that needs attention.



The main aim of the questionnaire was to capture the perception of how corruption in the home and host countries affected the attraction of FDI and operations in Guatemala. The questionnaire also addressed how the uncertainty created by corruption in Guatemala affected the strategy of foreign MNEs operating in the country and if some MNEs were better equipped to deal with this uncertainty. In order to make sure that the questionnaire covered all the important issues regarding how corruption affected FDI and how significant each item was, ranked responses were used. Finally, to ensure a higher rate of response the questionnaire did not present direct questions, instead the questions were carefully worded to avoid possible self-incrimination<sup>5</sup>

#### **4.9.8 Questionnaire Administration**

According to the Guatemalan Chamber of Commerce, 299 foreign MNEs are currently registered in this organisation and operating in the country. The questionnaires were administered to the whole sample of foreign MNEs registered at the Guatemalan Chamber of Commerce. The questionnaire was administered in two rounds. The first round was sent to the managers responsible for the Guatemalan operations from November 2012 to January 2013. The second round of questionnaires was distributed during a meeting held at the Guatemalan Embassy in Washington DC for foreign investors with operations in Guatemala.

#### **4.9.9 Language**

As with the interviews, the questionnaires were designed in English; however, the respondents were given the choice of answering them either in English or Spanish. In the same manner than with the interviews, the questionnaires were translated into Spanish by the researcher. After being translated into Spanish the questionnaires were translated back into English and compared to the original version to compare if they were consistent. When distributed, the respondents received both versions of the

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<sup>5</sup> A copy of the questionnaire can be found in the appendix.

questionnaires and were asked to choose the questionnaire with the language of their preference return it filled to the researcher.

#### **4.9.10 The Analysis**

The data from the questionnaires were evaluated using Multinomial Logistic Regressions. The Multinomial logistic regression was used to predict categorical placement in the probability of membership on a dependent variable (FDI range) based on multiple corruption independent variables. According to Starkweather and Moske (2011), the independent variables can be dichotomous (binary) or, as in this case, continuous (ratio in scale). Furthermore, the multinomial logistic regression is an extension of the binary logistic regression but the main difference with the latter is that the multinomial logistic regression allows for more than two categories of the dependent variable (FDI ranges) but does not assume a specific order of these (Starkweather & Moske, 2011).

Also, one of the most important reasons for using multinomial logistic regressions in this study is because it does not need careful considerations regarding sampling size and scrutiny for outlying cases, and furthermore, this regression does not assume, linearity normality, or homoscedasticity (Starkweather & Moske, 2011). However, the model does have a clear assumption, which is the independence between dependent variables. This assumption requires that dependent variables cannot be members of another category, in this case, FDI and a corruption variable, this condition is met.

The assumptions used for this research is that the dependent variable (FDI ranges) are independent from each other, and that their order does not affect the outcome of the results. According to Greene (2003) unordered-choice models can be caused by a random utility model by the  $i$ th respondent faced with  $J$  choices, and supposing that the utility choice  $j$  is

(11)

$$U_{ij} = Z'_{ij}\beta + \varepsilon_{ij}$$

If the respondent makes a choice  $j$  in particular then it is assumed that  $U_{ij}$  is the maximum amongst the  $J$  utilities. Therefore, the statistical model is guided by the probability that choice  $j$  is made, which is

(12)

$$\text{Prob}(U_{ij} > U_{ik}) \quad \text{for all other } k \neq j.$$

Greene (2003) says that this model is made operational by certain choice of distribution for the disturbances and can be used for the logistic and probit models. However, the probit model has had several limitations, which will not be discussed in this document since that particular model is not going to be used. The Logistic model, however, has been widely utilised in several fields including economics, market research, and business (Bull & Donner, 1987).

The logistic model assumes that  $Y_i$  is a random variable that indicates the FDI range chosen. Then Hausman and McFadden (1984) demonstrates that if (and only if) the  $J$  disturbances are independent and identically distributed with type I extreme value (Gumbel) distribution

(13)

$$F(\varepsilon_{ij}) = \exp(-e^{-\varepsilon_{ij}})$$

Then

(14)

$$\text{Prob}(Y_i = j) = \frac{e^{x'_{ij}\beta}}{\sum_{j=1}^J e^{x'_{ij}\beta}}$$

Which leads to what is called conditional logit model that is the base for the multinomial logistic model (Greene, 2003), which is

(15)

$$\text{Prob}(Y_i = j) = \frac{e^{\beta'x_{ij} + \alpha'w_i}}{\sum_{j=1}^J e^{\beta'x_{ij} + \alpha'w_i}} = \frac{e^{\beta'x_{ij}} e^{\alpha'w_i}}{\sum_{j=1}^J e^{\beta'x_{ij}} e^{\alpha'w_i}}$$

However, as it can be noted in formula (X) the terms do not change across alternatives specific to the individual. Therefore, if the model needs to allow individual specific effects, such as it is the case with foreign investors in Guatemala, then the model needs to be modified (Greene, 2003).

In order to allow for individual specific effects, a variation of formula (X) is used and it is called multinomial logistic regression (Greene, 2003)

(16)

$$\text{Prob}(Y_i = j) = \frac{e^{\beta'_j x_i}}{\sum_{k=0}^4 e^{\beta'_k x_i}}$$

Where  $j$  is FDI ranges choices for a decision maker, relating to each relationship  $i$  ( $i=1, \dots, N$ ), According to Greene (2003), the logit transformation of the estimated equations offer a set of probabilities for the  $J + 1$  choices for a decision maker with characteristics  $X_i$  of the individual/unique probabilities or choices to the estimated with the assumption of a normalisation of  $\beta_0 = 0$ . This rises since the probabilities sum to one; therefore only  $J$  parameter vectors are needed to determine the  $J + 1$  probabilities (Greene, 2003).

(17)

$$\text{Prob}(Y_i = j | \mathbf{x}_i) = \frac{e^{\beta'_j \mathbf{x}_i}}{1 + \sum_{k=1}^J e^{\beta'_k \mathbf{x}_i}}$$

#### 4.10 Ethical Issues of the Data Collection

This study received approval by the University of Edinburgh Business School. Also, all the participants of the research agreed to take part of it voluntarily. It is important to note that the participation of respondents for this research was agreed verbally since signing an agreement might be considered rude by some participants (Boyacigiller, et al., 2004). This was established based on the author's knowledge of the business etiquette in Guatemala where personal relations are highly regarded and verbal agreements are considered contracts. Also, due to the sensibility of the issue of how corruption affects managers' decisions, no contracts or written statements were formulated to secure an interview or to ensure that a questionnaire was filled.

Discussions about ethical issues in business research, and more specifically possible transgressions of them, usually revolve around a number of issues that reappear in different forms. Nevertheless, these issues have been usefully broken down by Diener and Crandall (1978) into four main areas: whether there is harm to participants; whether there is a lack of informed consent; whether there is an invasion of privacy; whether deception is involved.

During the data collection in this study (interviews and questionnaires) no harm of any type was inflicted in the respondents. This was achieved by fully explaining the nature of the research and how its results would only help explain how corruption affected the attraction of FDI to Guatemala without mentioning the identities of the sources. Also, all participants were fully informed of the aims and procedures of the research and only after the respondents consented to participate in the study did the data collection begin. The study also made sure to not invade any of the participants' privacy by maintaining the anonymity of all respondents. Finally, during the data collection the aims of the research and how the data gathered was going to be used was informed to every participant in their native language (either English or Spanish) in order to avoid the perception of deception.

#### **4.11 Summary of the Chapter**

In order to understand how high levels of corruption affect FDI inflows two approaches were taken. Firstly, a macroeconomic approach analysing FDI flows to Latin America was used. In this section, macroeconomic variables were used to represent determinants of FDI to the region and the Corruption Perception Index from Transparency International as a measure of corruption. This study argues that the level of corruption in the host country by itself is not the only reason why corruption deters FDI. Instead, this study claims that it is the difference between the corruption levels between the home and host country what deters FDI.

Nevertheless, analysing how corruption and corruption distance affect FDI a macroeconomic analysis does not provide a full picture of the issue. For this reason, a firm-level analysis was needed to answer the research question: Why are some foreign firms less negatively affected than others by high levels of host country corruption when investing abroad? This section of the study utilised a mixed methodology to understand how corruption affected the attraction of FDI to a highly corrupt country. Firstly, a series of interviews were conducted to analyse how corruption affected the process of allocating investment to Guatemala. Secondly, a

questionnaire was developed to survey decision-makers to ask them how corruption affected FDI.

## **CHAPTER FIVE: RESULTS OF THE ANALYSIS**

### **5.1 Introduction**

This chapter presents the results of how corruption affects the attraction of FDI to a highly corrupt foreign location. The first section of this chapter addresses the research question: a) How does corruption distance between home and host country affect the attraction of FDI to emerging markets? To answer this research question, this section analyses how corruption and corruption distance affect the attraction of FDI to 12 Latin American countries from the years of 2006 to 2009. The results were obtained by analysing panel data with the aid of a random effects model. On the other hand, the firm-level results were obtained from a mixed methodology that used semi-structured interviews and questionnaires administered to managers responsible for allocating FDI to Guatemala.

The second section of the chapter analyses the research question: b) Why are some foreign firms less negatively affected than others by high levels of host country corruption when investing abroad? To answer this research question, twelve in-depth semi-structure interviews were conducted to analyse how decision makers were affected by high levels of corruption in a foreign location when investing. Furthermore, from the answers provided to the interviews, questionnaires were designed to reach a larger sample of decision makers to analyse how corruption affected their decision to invest in a highly corrupt foreign location, and how corruption affected subsequent operations in such location.

### **5.2 Macroeconomic Level Results**

The Pearson's Correlations matrix results for the full sample of FDI to Latin America from 2006 to 2009 are presented in Table 6. The correlation matrix includes FDI flows to 12 Latin American host countries in the period described above. The matrix includes the Corruption Perception Index (CPI) to capture the level of corruption of



the host countries, a dichotomous variable describing whether or not a host country have a corruption level higher (denoted as 1 in the model) or lower (denoted as 0 in the model) than the host countries. Corruption distance was represented as the level of corruption of the home country minus the level of corruption of the host country as measured by Transparency International for the period of 2006 to 2009. Finally, the control variables were also represented by several indices published by recognised international organisations.

The Karl Pearson Correlation matrix coefficient is used to quantitatively measure the extent to which two variables are correlated (Sharma, 2011). According to Sharma (2011), the coefficient determination, denoted by  $r^2$ , always has a value between 1 and -1. This coefficient is used to discover a linear covariation of two variables. This coefficient is preferred to determine the strength of relationship between two variables because since it is a percentage, it is easier to be interpreted. Moreover, there is no definite rule stating which coefficient denotes correlational strength; however, Jackson (2011) offers the following guidelines:

- $0 < |r| < 0.3$  weak correlation
- $0.3 < |r| < 0.7$  moderate correlation
- $|r| > 0.7$  strong correlation

Based on the guidelines provided by Jackson (2011), corruption has a weak negative correlation with FDI flowing to Latin America; however, this correlation is statistically significant at the  $p < 0.10$ . When analysing the correlation between corruption distance and FDI, the relationship is stronger, however. As presented in Table 6, corruption distance shows a strong negative correlation with FDI to Latin America when the home countries have lower levels of corruption than the host region, and this relationship is significant at the  $p < 0.001$  significance level. Corruption distance, when analysing home countries with higher levels of corruption

than the host countries, is positive and weakly correlated with FDI to Latin America, however this correlation is statistically significant at the  $p < 0.10$ .

As presented in Table 6, there are several strong correlations statistically significant in the Pearson's Correlation matrix studying corruption, and its effect on FDI to Latin America. One of these variables includes Corruption Distance when the host region is more corrupt than the home region. This factor could mean that collinearity is present in the data; nevertheless, the tests performed on the data, and presented in the appendix of this document, did not reveal any important issues of multicollinearity in the dataset.

Table 6 shows how FDI and corruption correlate in the Latin American region. The results of the correlation matrix show statistical significant negative relationship between FDI and the corruption level in the host countries at a  $p < 0.10$ . Corruption distance presents a strong negative correlation at the  $p < 0.001$  level between corruption distance and FDI when the host countries have a lower corruption level than home countries. On the other hand, corruption distance shows a significant positive correlation at the  $p < 0.10$  level with FDI when the host countries experience higher levels of corruption than the host countries.

The random effects regression results for the full sample are presented in Table 7. In this table three models are run. Model 1 analyses how corruption affects the total FDI flows to Latin America and excludes the corruption distance variables. This is made to understand how corruption affects FDI flows to Latin America. The result from Model 1 is that the total amount of FDI received in Latin America is negatively affected by high levels of corruption of the host countries. This result is statistically significant at a level of  $p < 0.10$ .

Model 2 analyses how corruption distance affects home countries with lower corruption levels than the host countries. The result shows that corruption distance is

negatively associated ( $p < 0.10$ ) with FDI flows when home countries have a lower level of corruption than host countries experiencing high levels of corruption. Model 2 also shows that investors from countries with lower levels of corruption than the host country are negatively affected by high levels of corruption of the host country.

Finally, Model 3 tests what effect corruption distance has on the attraction of FDI to a highly corrupt region when the home countries are more corrupt than the host countries. In this model the corruption distance from home countries with lower levels of corruption than the host countries are excluded. The results show that corruption distance has a positive effect on FDI flows from countries with higher corrupt levels than an already highly corrupt host region; however, this relationship is not statistically significant.

The correlations matrix shows significant correlations between variables. Nonetheless, these correlations were expected due to the nature of the variables chosen, as described before. However, to make sure that multicollinearity was not present in the model this research conducted a 'Tolerance or Variation Inflation Factor (VIF)' test as used in (Buckley, et al., 2007). In order to have a 'standard of safety' the VIF coefficients should not exceed 10 (O'brien, 2007).

Table 6: Pearson's Correlation Matrix for Macroeconomic Analysis

FDI	1												
CPI	-0.17*	1											
CorrDis1	-0.20	-0.77***	1										
CorrDis2	-0.21	-0.45**	0.29*	1									
Human	0.50***	-0.47***	-0.35*	0.1457	1								
Law	0.37**	-0.88***	-0.75***	0.31*	0.64***	1							
Bureaucracy	-0.002	0.58***	0.46***	-0.07	-0.39**	-0.47**	1						
EcFreedom	-0.25*	-0.24*	-0.17	0.15	-0.03	0.24	-0.62***	1					
Education	-0.21	0.33*	0.58***	0.11	-0.15	-0.38**	0.13	0.08	1				
Inflation	0.06	0.06	-0.07	0.13	-0.23	-0.8	0.39**	-0.36*	-0.15	1			
Infrastructure	0.38**	-5.59***	-0.41**	0.13	0.81***	0.73***	-0.38**	-0.06	-0.25*	-0.22	1		
GDP	0.46***	0.22	0.06	-0.26	0.57***	0.25*	-0.26*	-0.22	0.01	-0.30*	0.57***	1	
Unemployment	0.22	-0.24*	-0.02	-0.3	0.48**	0.35*	-0.29*	-0.05	0.25*	-0.21	0.46**	0.40**	1

Significance levels: \*, \*\*, and \*\*\* denote significance of 10%, 5% and 1% respectively

Table 7: Results Random Effects Regression for Macroeconomic Analysis

Dependent Variable: FDI			
	Model 1	Model 2	Model 3
CPI	-6.77038*		
CorrDis1		-13.8663*	
CorrDis2			1.083765
Human	122.8364*	183.0966*	185.2531*
Law	0.4614521**	1.61422***	1.86183***
Bureaucracy	0.11224919	0.2697496	0.940995
EcFreedom	-0.1567881	0.4805634	-0.8639065
Education	-1.028834	1.403908	0.3784996
Inflation	0.7107626	0.6078531	0.6981451
Infrastructure	-0.5448595*	-1.10931*	-1.332644*
GDP	6.829546*	4.799764	2.94363
Unemployment	-2.371313	-2.442756	-2.846843
Model Summary			
No. Observations	48	48	48
No. Host Countries	12	12	12
Wald Chi2	57.9	62.76	54.1
Prob>chi2	***	***	***

Significance levels: \*, \*\*, and \*\*\* denote significance of 10%, 5% and 1% respectively

### 5.2.1 Model Fit

To ensure the accuracy of the results, multicollinearity tests were performed as presented in the appendix. Also, to ensure minimum problems several assumptions were made. According to Baltagi, et al., (2003), one of the most important issues that panel data can present is endogeneity. Endogeneity occurs when there is a correlation between the parameter or variable and the error term. Furthermore, this

issue can arise due to measurement error, an autoregression with autocorrelated errors, simultaneity and omitted variables.

Nevertheless, in the social sciences there is always the possibility of finding endogeneity since the social sciences seek to understand the behaviour of people. For this reason, Reichstein (2011) argues that in the social sciences researchers cannot establish a laboratory-like environment to run experiments in order to keep the *ceteris-paribus* assumptions. Therefore, Reichstein (2011) suggests that to minimise the effects of endogeneity the researcher must (1) choose the appropriate model, (2) collect appropriate data, and (3) include appropriate proxies for possible omitted variables. In this study, all three conditions were met. The random effects model corrects for differences across entities have some influence the dependent variable (Moulton, 1986). Also, the data collected does not include missing values; finally, the proxy variables for time can be introduced in the random effects model (Moulton, 1986).

Finally, to test whether or not there was cross-sectional dependence between variables, a Pasaran CD (cross-sectional dependence) test was used. The Pasaran CD test supported the null hypothesis that residuals were not correlated with an index of 0.1624. Finally, in order to test heteroskedasticity we used a Likelihood Ratio (RL) Test that showed no correlation at 1.00 (Drukker, 2003).

### **5.3 Firm-Level Results**

The empirical data used to explain the results of the study consists of a unique firm-level data set obtained from interviews and questionnaires administered to foreign investors registered with the Guatemalan Chamber of Commerce. Currently the Guatemalan Chamber of Commerce has 299 foreign MNEs listed. The first stage of the data gathering involved twelve in-depth semi-structured interviews that were used to develop a questionnaire to be administered to the entire sample. The questionnaire was also developed by emulating questions from questionnaires used

by two well-known institutions researching how corruption affects businesses in Guatemala, which are: Transparency International and The World Bank (The World Bank, 2005; Transparency International, 2011). The questionnaire also resembles questions used in academic publications<sup>6</sup> (Uhlenbruck, et al., 2006; Jensen, et al., 2010).

The selection of respondents for the interview followed the following rationale: Six managers of MNEs located in countries with a lower corruption level than Guatemala, and six from MNEs located in more corrupt countries<sup>7</sup>. Even though the MNEs were from different countries and operated in different industries several similarities were found. When talking to managers of MNEs from highly corrupt countries they described corruption as another obstacle for doing business, but not a serious one. Moreover, they agreed on the fact that corruption only slowed operations in a foreign country but was not consider a ‘deal breaker’. On the other hand, when talking to managers from MNEs located in countries with a lower level of corruption than Guatemala different issues arose. These managers saw corruption as a serious problem that developing countries faced. They also expressed concerns regarding the lack of knowledge of how to deal with corrupt local officials, and the need to adapt to local corrupt practices, which contradicted their behaviour in their home country.

### **5.3.1 Results from the Interviews**

The results of the twelve interviews conducted provide an insight of how corruption affects the allocation of FDI in a highly corrupt host country. The profiles of the firms selected for the interview are provided in Table 4. As previously mentioned, of the twelve interviews six firms were headquartered in countries with higher levels of corruption than Guatemala, while the rest are located in a home country with lower

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<sup>6</sup> See appendix for complete questionnaire

<sup>7</sup> The levels of corruption were taken from the Transparency International Corruption Perception Index

corruption levels than the host country. The results of how corruption affects FDI to Guatemala depending on the corruption levels of the home country are provided below.

As shown in Table 8, firms located in countries with higher corruption levels than Guatemala decided to invest in the country to gain access to the host market. Also, the entry mode preferred by these firms was joint venture. When asked about whether or not they had other foreign subsidiaries in the Latin American region, four out of six interviewees declared to not have them. On the other hand, investors from countries with lower corruption levels than Guatemala preferred to penetrate the market via wholly owned subsidiaries and they declared to have subsidiaries in other Latin American countries. Moreover, the motives for FDI in Guatemala for firms with lower corrupt levels than Guatemala declared that their motivations were evenly distributed in the three main motivations of FDI (market, resource, and efficiency-seeking).

Table 9 presents the main answers of managers in charge of allocating FDI to Guatemala about how corruption affected their decision making process and subsequent operations in the country. Firms from more corrupt countries also agreed that making illegal payments to local officials was not morally acceptable but they justified doing it as a ‘means to an end’ approach. All the interviewees justified paying bribes to local Guatemalan officials by saying that if they did not do this they would go out of business and their employees would suffer. These managers also acknowledged that personal connections with local officials in all three major areas of the public sector in Guatemala (elite, judiciary, and bureaucracy) were crucial to expedite processes to operate in the country.

According to Investor 1, corruption, although detrimental for a society, is sometimes necessary to expedite processes. This manager argued that although corruption should not exist, there is little a single company can do about it. Investor 1 also declared that the uncertainty generated by corruption in Guatemala was minimal



since ‘everybody knows the country is highly corrupt’ and knowledge of how to deal with corruption in Guatemala could be obtained at the home country. Furthermore, this manager argued that if his company did not engage in corrupt deals, the well-being of the company and the employees could be in jeopardy. Furthermore, in the words of the interviewee:

*Corruption is morally wrong. However, sometimes managers have to engage in corrupt deals in order to be able to generate business. If I had a choice, of course I would not participate in corrupt deals, but the reality is that if you want to operate in Guatemala without engaging in corruption, you won't get very far.*

The view expressed by Investor 1 was echoed by Investors 3, 5, and 6. According to these managers, corruption should not exist and it is detrimental for businesses as well as all sectors of a society. Nevertheless, these investors also argued that if they want to continue operating in Guatemala, they have to comply with the local ‘business culture.’ Moreover, these investors also agreed that corruption in Guatemala did not increase uncertainty when doing business in the country since they had familiarity of the possible illegal requirements requested by local public officials. The one difference between these investors, however, is how they replied to whether or not to have acquired knowledge of how to deal with corruption at home.

Table 8: Profile of firms interviewed

<b>Investor</b>	<b>Level of Corruption</b>	<b>Amount Invested in Past 5 Years</b>	<b>Motivation for FDI in Guatemala</b>	<b>Ownership Structure</b>	<b>Other Subsidiaries in Latin America</b>
Investor 1	More Corrupt	Up to US\$1 million	Market-seeking	Joint Venture	No
Investor 2	More Corrupt	Between US\$10 and US\$20 million	Market-seeking	Joint Venture	Yes
Investor 3	More Corrupt	Between US\$5 and US\$10 million	Efficiency-seeking	Joint Venture	Yes
Investor 4	More Corrupt	Up to US\$1 million	Market-seeking	Wholly Owned Subsidiary	No
Investor 5	More Corrupt	Between US\$5 and US\$10 million	Market-seeking	Joint Venture	No
Investor 6	More Corrupt	Between US\$5 and US\$10 million	Market-seeking	Joint Venture	No
Investor 7	Less Corrupt	Between US\$10 and US\$20 million	Market-seeking	Wholly Owned Subsidiary	Yes
Investor 8	Less Corrupt	Between US\$10 and US\$20 million	Efficiency-seeking	Wholly Owned Subsidiary	Yes
Investor 9	Less Corrupt	Between US\$20 and US\$30 Million	Efficiency-seeking	Wholly Owned Subsidiary	Yes
Investor 10	Less Corrupt	More than US\$30 million	Resource-seeking	Joint Venture	Yes
Investor 11	Less Corrupt	Between US\$5 and US\$10 million	Resource-seeking	Wholly Owned Subsidiary	Yes
Investor 12	Less Corrupt	Between US\$20 and US\$30 Million	Efficiency-seeking	Wholly Owned Subsidiary	Yes

Jose Godinez

According to Investor 5

*There is no recipe of how to deal with corruption in any place even if it is your own country. The only thing you can do, though, is to experience it and then adapt to respond to the environment on which you operate and this includes corruption*

On the other hand, Investor 3 declared that

*Managers do not need to learn how to deal with corruption but how to deal with people with different customs*

Within the same line of thought than Investor 3, Investor 6 declared that when replying whether or not knowledge about how to cope with corruption in a foreign country can be acquired at home replied:

*Managers should acquire knowledge of how to deal with people and not with their beliefs. You cannot change how a person acts, but you can change how you react to their actions. I possess knowledge of how to deal with people, and that has helped me conduct business at home and abroad.*

An interesting issue arose when talking to Manager 4. According to this manager, corruption *per se* does not exist. Instead, this manager declared that people instead of talking about corruption should be talking about culture. Manager 4 declared that just because certain countries did not understand business practices abroad did not mean that they were wrong. Although this manager agreed that providing illegal payments to public officials could affect the bottom line of a business, managers should adapt to this because otherwise they would go out of business. Moreover, this manager described corruption in Guatemala as

*...something everyone does whether they accept it or not.*

Jose Godinez

Finally, not all investors from a country with higher levels of corruption than Guatemala ‘condoned’ corruption. According to Investor 2, corruption does not have a logical reason to exist. According to this respondent, if the system was transparent and fair to all parties, public officials as well as companies would not have an incentive to participate in corrupt deals. Finally, this investor declared that even though the experience at home might provide some knowledge about how to deal with corruption since

*No one can totally learn how to deal with corruption at home or abroad. However, the experience at home taught us where we should expect illegal requests to take place*

On the other hand, when talking to managers of MNEs headquartered in countries with a lower corruption level than Guatemala there was consensus regarding how corruption affected the decision-making process of allocating of FDI in Guatemala: corruption was a serious factor to take into account but not *the* only factor. According to these managers, corruption delayed and increased prices of projects, but did not dictate whether or not investment was going to be made. The respondents also said that the corruption level of the host-country could affect the duration of the project, the quality of the work performed, and the entry-mode used (either wholly-owned subsidiary or joint venture).

Although investors from countries with lower level of corruption than Guatemala agreed that corruption was not acceptable, their views on several issues differ from one another. According to Investors 7, 10, and 12 corruption is not only morally wrong but also the cause of the poverty around the world, and a cancer to society. Furthermore, this investor firmly declared not to engage in any corrupt deal in any market where the company operates. This manager also argued that the uncertainty levels that corruption generates can actually dictate whether or not a foreign investment is made. However, this manager stated that even though corruption is

present in all aspects of the Guatemalan public sector its impact is different. According to Investor 7:

*Corruption in Guatemala is widespread and ingrained in all aspects of the public sector. However, the costs of corruption in the bureaucratic sector are minimal when compared with the costs of corruption in the government elite or the judiciary sector*

Investors 7, 10, and 12 also declared that they did not have the opportunity to learn at home how to deal with high levels of corruption abroad. These three investors also agreed that their home countries are not ‘corruption-free’ but that this problem is mainly present in the public sector, and since they do not do business with their government, they can avoid corrupt deals.

On the other hand, there were two interviewees from countries with lower corruption levels than Guatemala that did not ‘demonize’ corruption as Investors 7, 10, and 12. According to Investors 8 and 9, corruption is a major factor that might impede business, but it is not the only one. Furthermore, according to these respondents, corruption should be avoided when possible, but this cannot be done in all situations. Another difference between Investors 8 and 9 and Investors 7, 10, and 12 is that the former agreed that corruption is predictable in Guatemala. According to Investor 8,

*Corruption is more frequent when doing business with the Guatemalan government. After learning that there was no way to not engage in corrupt deals when working with the government we just decided to avoid such contracts*

Finally, Investor 9 declared that corruption is very predictable in Guatemala and even though it helps expedite processes it should be avoided when possible.

Table 9: Summary of answers from decision-makers regarding corruption and FDI in Guatemala

Investor	Level of Corruption	Personal Views of Corruption	Engaging in Corruption in Guatemala	Uncertainty Due to Corruption	Corruption Among Different Levels of Government	Acquired Knowledge of how to Cope with Corruption
Investor 1	More Corrupt	Corruption is morally wrong. However, sometimes it is necessary to continue in business	Corruption is very common in all the aspects of Guatemalan operations. Unfortunately, sometimes bribing officials is not optional	Corruption affects businesses and increases uncertainty but the firm needs to adapt quickly	Although corruption is rampant, the problem is more prevalent in the bureaucracy	Knowledge of how to approach a corrupt official (bureaucrat) was acquired at home
Investor 2	More Corrupt	Corruption should not exist and firms should not engage in it.	Corruption is engrained in all sectors of the Guatemalan society. It is very difficult to not engage in it	When investing in Guatemala we had knowledge of the problem in the country. Uncertainty was minimal	Corruption is more widespread among bureaucrats. However, the other two branches of public life are also corrupt but more cautious as to publicly engage in corrupt deals	No one can totally learn how to deal with corruption at home or abroad. However, the experience at home taught us where we should expect illegal claims
Investor 3	More Corrupt	Corruption is wrong, but it is understandable since some public officials need to complement their wages.	It is how business is conducted in the Country "when in Rome"	There is no uncertainty due to corruption. No one is surprised by corruption in Guatemala	People think that the bureaucratic sector is more corrupt. The other two sectors are equally or more corrupt but they are not as visible	There is no need to know how to deal with corruption. You should learn to deal with people of different customs
Investor 4	More Corrupt	"I do not believe that there is such thing as corruption. People only have different business cultures"	That is how everybody does business. It is part of the business culture of the country	There is no uncertainty if you know what you will encounter	All sectors operate differently. The government elite ask for a percentage of the project; the judiciary only responds to the elite; bureaucrats request little contributions	Public officials operate very similarly everywhere where we operate

Investor 5	More Corrupt	Corruption is wrong but if I do not comply, I do not have a business and cannot offer employment	There is no other option but to comply with the local conventions	Sometimes you do not know what a public official will ask but that is the exception rather than the rule	Corruption among the bureaucrats and judges is constant. With the elite it changes after every election	Nothing can fully prepare you to deal with corruption abroad; but, after having operations in the country you learn what to expect
Investor 6	More Corrupt	It should not be acceptable but it is the only way to do business sometimes	That is how business is conducted in the country	There is no uncertainty when you know what to expect	Everybody is corrupt but in different forms. Every sector asks for different illegal payments depending on who you are and what you do	I possess knowledge of how to deal with corrupt people. You just wait to see what their requirements are. You do not offer anything until then
Investor 7	Less Corrupt	Corruption is not only morally wrong but it is the main cause of poverty around the world	We try to not engage in any corrupt deal whenever possible	Uncertainty is very high when doing business in Guatemala. Local officials believe they can request unlimited bribes	Bureaucrats are highly corrupt but their impact in the bottom line is minimal. Corruption among senior officials makes a dent in our bottom line, though	Absolutely not. Of course there is corruption at home but nothing even close than Guatemala
Investor 8	Less Corrupt	Corruption is a major impediment for business abroad but not the only factor to take into account	As far as I know we do not engage in corrupt deals	Corruption occurs more often when doing business with the government. We try to avoid that	Corruption is widespread in all sectors of the government.	No, at home it is known that there is corruption in government contracts but we do not participate in those
Investor 9	Less Corrupt	Corruption is morally wrong. Sometimes it is unavoidable though	We try not to engage in corruption at large scale. I have to admit that to expedite some processes we have had to resort to alternative means	Corruption in Guatemala is very predictable as well as its costs	There is no sector in the Guatemalan government corruption free	Corruption at home is not uncommon. However, due to cultural differences I do not believe that corruption at home helped cope with corruption in Guatemala
Investor 10	Less Corrupt	Corruption is wrong and should be combatted	Absolutely not. We have to demonstrate that it is possible to turn a profit being honest	Uncertainty can be high but once officials see how we do business they do not bother us	Unfortunately corruption is rampant in the country at all spheres	I am sure there is corruption at home but we have a zero tolerance policy at home and abroad
Investor 11	Less Corrupt	Corruption is wrong and delays processes	Unfortunately you have to play by the local rules but we avoid it when we can	In general there is no uncertainty but of course there are exceptions	Bureaucrats request more bribes but the other two sectors request larger amounts of money	No. Corruption is present at home but it takes different forms than in Guatemala
Investor 12	Less Corrupt	Corruption is a cancer of a society	We have too much to lose if we engage in corrupt deals	We do whatever we can to avoid engaging in corruption	Corruption is widespread in Guatemala but with companies that work with the government	We never participated in corrupt deals at home. No knowledge was acquired then

In summary, while interviewing managers of MNEs from less corrupt countries than Guatemala interesting and surprising issues arose. These managers all agreed that corruption was detrimental to doing business and a very important factor to take into account when deciding to invest in a foreign location. Corruption, according to these respondents, was the root of all problems in the country. Corruption, according to them, divests private funds to a few government employees, increases inefficiencies, and hence deepens the poverty levels in the host country. Managers of MNEs from less corrupt countries than Guatemala also expressed that corruption is as an 'evil force' that needs to be stopped. For that reason, they expressed that if given the choice they would choose a wholly owned subsidiary over a joint venture in order to have total control to curb any wrong-doings. These managers also expressed concern in the levels of corruption in several areas of the government in the country.

One interesting finding, however, was that even though all the managers from less corrupt countries viewed corruption as a serious problem that needed to be eliminated; however, their operations in the host country told a different story. These managers admitted that in order to do business in a corrupt environment like Guatemala's they needed to adapt to local social conventions that might not be acceptable in their home-countries. They argued that making illegal extra payments and providing kickbacks to local officials was, sometimes, necessary to keep the business going. One important point to be raised, however, is that the decision to invest in a foreign country does not depend only on the corruption levels of such location to these managers. Instead, how to invest in a highly corrupt foreign location is dictated by the levels of corruption. Nevertheless, once such decision has been made, operating in a highly corrupt country with a different business culture than at home is a totally different game and will be described later in this study.

Finally, an important finding of this study is the fact that it appears that acquiring knowledge of how to deal with corruption at home might help to cope with corruption abroad. Also, the interaction between corruption levels of the home and



host country might be more important to analyse how corruption affects FDI than the level of corruption of the host country alone. This claim can be explained because MNEs based in highly corrupt home countries might not see corruption abroad as a deterrent for FDI since they are used to operating in such environments in their home country. Also, since corruption is the norm in the home country, these MNEs might not face pressures at home to abstain of investing in highly corrupt foreign locations. On the other hand, firms located in countries with low levels of corruption might be deterred by the uncertainty that corruption in the host country represents. Furthermore, these firms might also face pressures at home for not conducting business in foreign locations considered as highly corrupt.

### **5.3.2 Limitations of the Interviews**

Despite the invaluable insights learned from the interviews, they could not provide the whole picture needed to understand how foreign investors react to corruption in Guatemala. Therefore, the interviews were used to craft a questionnaire that would (a) reach more respondents to have a more representative sample, and (b) provide the anonymity respondents needed to answer sensitive questions regarding corruption. The questionnaire was developed to reflect how MNEs react to the perception of corruption in their home country as well as in the host country. It also sought to quantify the uncertainty created by corruption in the host country, the strategy created to minimise the effects of corruption, the previous knowledge acquired to deal with corruption, and how corruption affects the already established operations in Guatemala. The questionnaires were sent to the whole population of MNEs operating in Guatemala in the period of November 2012 to January 2013. The questionnaires were distributed in two rounds. Firstly they were personally handed to the highest ranking manager in Guatemalan from November 2012 until February 2013, which provided 53 questionnaires filled. Secondly, at a meeting of foreign investors in Guatemala held in Washington DC, questionnaires were handed to all attendants in

January 2013, which provided the remaining 36 questionnaires obtained for a total of 89 questionnaires received.

#### 5.4 Results from the Questionnaires

At the end of the two rounds of data gathering 89 questionnaires were received. Of those, 32 questionnaires were not useful because they were not completed and/or they omitted answers that were necessary to analyse how corruption affects FDI in Guatemala. After scrutinising all the questionnaires filled, the total amount of usable questionnaires was 57 (19.06% of the total population) of which 34 were comprised by MNEs located in countries with a lower corruption level than Guatemala, and 23 located in a more corrupt country. Although the response rate might seem low it is important to note that due to the nature of the study a 19% response is actually very significant. In addition, since the questionnaire had to be answered by decision makers in charge of selecting FDI destinations the response rate becomes even more substantial.

Table 10: Descriptive Statistics of Entry Mode of MNEs in Guatemala from 2007-2012

	<b>Less Corrupt</b>	<b>More Corrupt</b>
<b>Structure</b>		
Joint Venture	6 (17.65%)	15 (65.22%)
Brownfield (WOS)	11 (32.35%)	4 (17.39%)
Greenfield (WOS)	17 (50%)	4 (17.39%)
<b>Total</b>	<b>34</b>	<b>23</b>

Source: Author's questionnaires

Table 10 presents a description of the entry mode that foreign companies have adopted to penetrate the Guatemalan market. The vast majority (82.35%) of MNEs from less corrupt countries chose a wholly owned subsidiary (WOS) as their entry strategy. According to managers from MNEs located in less corrupt countries, they

preferred WOS due to the control that this entry mode provides. These managers also expressed that the choice between greenfield and brownfield depended solely on the existence of a local firm that was attractive and at a reasonable price. On the other hand, MNEs from more corrupt countries preferred joint ventures (JVs) for economic reasons, according to the respondents. Table 10 presents the sector on which investment was made in Guatemala during the period 2007-2012 presented in motivations for FDI. For both, more and less corrupt countries, the manufacture and services sectors were more attractive, while the natural resources and agriculture sectors were not. The amount invested in the country also has differences between MNEs from either more or less corrupt countries than the host country. As presented on Table 3, MNEs from less corrupt countries made larger investments in the host country than those located in more corrupt countries within the 2007-2012 period.

Table 11: FDI motives of responding firms from 2007-2012

	<b>Less Corrupt</b>	<b>More Corrupt</b>
<b>Motive</b>		
Efficiency Seeking	11 (32.36%)	9 (39.14%)
Market Seeking	12 (35.28%)	10 (43.48%)
Resource Seeking	11 (32.36 %)	4 (17.38%)
<b>Total</b>	<b>34</b>	<b>23</b>

Source: Author's questionnaires

For MNEs from countries with a lower corruption level than Guatemala the distribution of FDI in the country was evenly allocated in the three main motives for the country. For these MNEs the main motivation for investment in the country was market seeking with 35.28% of the total investment in the period of 2007 to 2012. During the same period, both efficiency seeking and resource seeking FDI accounted for 32.36% each of the total FDI allocated in the country. For MNEs headquartered

in countries with higher corruption levels than Guatemala market seeking was the main motivation for investing in the country. According to the data gathered by the author of this study, 43.48% of respondents indicated that the main motivation to invest in Guatemala was market seeking. The second most popular motive for investment in the country for MNEs from more corrupt countries was efficiency seeking with 39.14% of respondents stating this as their main motivation. Finally, for the period of 2007 to 2009, MNEs from countries with higher corruption levels than Guatemala declared that only 17.38% of the FDI allocated in the country had a resource seeking motivation.

Table 12: Amount of FDI to Guatemala for the period 2007-2012

	<b>Less Corrupt</b>	<b>More Corrupt</b>
<b>Amount of FDI</b>		
Up to US\$1 million	0 (0%)	3 (13.04%)
Between US\$5 and US\$10 million	6 (17.65%)	9 (39.14%)
Between US\$10 and US\$20 million	10 (29.4%)	8 (34.78%)
Between US\$20 and US\$30 million	11 (32.36%)	3 (13.04%)
More than US\$ 30 million	7 (20.59%)	0 (0%)
<b>Total</b>	<b>34</b>	<b>23</b>

Source: Author's questionnaires

In order to analyse which factors affected the attraction of FDI in Guatemala at the firm level, the answers to the questionnaire were utilised as variables for multinomial logistic regressions. Table 12 presents how variables of the motives for FDI, entry mode, and previous presence in the Latin American region affected FDI flows to Guatemala. Model 3 shows that none of these factors affected FDI flows to

Guatemala from MNEs located in countries with higher corruption levels than a host country with high levels of corruption. On the other hand, for MNEs located in less corrupt countries than the host country, having already an established presence in the region showed a positive and statistically significant relationship at  $p < 0.10$  with FDI flows to the host country as presented in Model 4.

Table 13: Multinomial Logistic Regression of FDI in Guatemala

<b>Variable (Coefficient)</b>	<b>Model 3 (Less Corrupt)</b>	<b>Model 4 (More Corrupt)</b>
Intercept	52.150 (2.268)*	38.732 (4.139)*
Entry Mode	50.230 (0.347)	42.281 (7.7687)
Motive	56.344 (6.462)	37.821 (3.228)
Subsidiaries	59.205 (9.323)*	35.349 (0.756)
<b>Model Fit</b>		
Deviance (-2 log likelihood)	49.882 (16.619)*	34.593 (11.498)*
Cox and Snell	0.387	0.393
Nagelkerke	0.414	0.427
McFadden	0.180	0.197
N	34	23

Significance levels: \*, \*\*, and \*\*\* denote significance of 10%, 5% and 1% respectively

Table 13 presents the responses of managers (FDI decision-makers) of MNEs operating in Guatemala and their perception of their knowledge of whether or not they would face corruption in this host country. The results show that both, foreign MNEs headquartered in either more or less corrupt countries than Guatemala face corruption in the host country in the three main sectors of the public sector. The data gathered shows that for MNEs from countries with lower corruption levels than

Guatemala the probabilities of facing corruption with Guatemala's political elite is 55.9%; with the judiciary system, 55.9%; and with the bureaucratic sector, 94.1%.

Table 14: Likeness of Facing Corruption in Guatemala by Sector 2007-2012

Likeliness of Facing Corruption in Guatemala					
	Very Unlikely	Unlikely	Neither likely nor unlikely	Likely	Very Likely
<b>Political elite</b>					
More corrupt	0 (0%)	1 (4.3%)	10 (43.5%)	11 (47.9%)	1 (4.3%)
Less corrupt	0 (0%)	2 (5.9%)	13 (38.2%)	15 (44.1%)	4 (11.8%)
<b>Judiciary system</b>					
More corrupt	0 (0%)	3 (13%)	8 (34.8%)	9 (39.2%)	3 (13%)
Less corrupt	0 (0%)	3 (8.8%)	12 (35.3%)	14 (41.2%)	5 (14.7%)
<b>Bureaucrats</b>					
More corrupt	0 (0%)	0 (0%)	2 (8.7%)	14 (60.9%)	7 (30.4%)
Less corrupt	0 (0%)	0 (0%)	2 (5.9%)	13 (38.2%)	19 (55.9%)

Source: Author's questionnaires

Table 14 also presents the responses of managers of MNEs located in countries with higher corruption level than Guatemala and their perception of how likely they are of facing corruption in the host country. MNEs from countries with higher corruption levels than Guatemala expressed that their probability of facing corruption with the political elite of the host country is 52.2%, which is the same rate for the judiciary system; and in the bureaucratic sector, 91.3%.

As shown in Table 14, managers from foreign MNEs operating in Guatemala are aware of the high levels of corruption of the host country. Table 13 presents how much the perception of corruption affects the attraction of FDI to Guatemala. Table 14 shows that corruption in Guatemala's government elite, the judiciary and

bureaucratic sectors does not affect the attraction of FDI to the host country. These results can be explained by the fact that decision-makers have knowledge of the corruption levels in Guatemala and the corruption level was taken into account when deciding to invest in the country.

Table 15: Multinomial Logistic Regression Facing Corruption in Guatemala by Government

<b>Variable (Coefficient)</b>	<b>Model 5 (Less Corrupt)</b>	<b>Model 6 (More Corrupt)</b>
Intercept	41.693 (2.239)*	43.398 (1.820)*
Government Elite	41.962 (2.508)	42.225 (0.647)
Judiciary System	41.140 (1.686)	42.305 (0.727)
Bureaucrats	41.154 (1.700)	43.021 (1.443)
<b>Model Fit</b>		
Deviance (-2 log likelihood)	39.454 (5.493)*	41.579 (3.127)*
Cox and Snell	0.149	0.127
Nagelkerke	0.160	0.138
McFadden	0.060	0.054
N	34	23

Significance levels: \*, \*\*, and \*\*\* denote significance of 10%, 5% and 1% respectively

Researchers have argued that there are two dimensions of corruption, arbitrariness and pervasiveness (Doh, et al., 2003). In order to capture how these two dimensions of corruption affected foreign investors in Guatemala, questions regarding the uncertainty that corruption in the host country were asked. As presented in table 15, MNEs from more corrupt countries than the host country have a slight advantage when dealing with pervasive corruption in Guatemala with a 43.5% of respondents

stating that they possessed knowledge of how much an unofficial payment will be, compared with an 35.3% of respondents from less corrupt countries. Managers from more corrupt countries also showed an advantage when dealing with arbitrary corruption in Guatemala. Table 6 shows that 47.8% of managers from more corrupt countries had knowledge of whether or not an extra unofficial payment will be needed after already making an initial payment. Similarly, MNEs from less corrupt countries said that they had such knowledge at a 41.4% rate.

Table 16: Arbitrariness and Pervasiveness of corruption in Guatemala 2007-2012

Arbitrariness and Pervasiveness of Corruption in Guatemala					
	Not at all	No	Neutral	Somewhat yes	Yes
<b>Knowledge of price of unofficial payments</b>					
More corrupt	0 (0%)	2 (8.7%)	11 (47.8%)	8 (34.8%)	2 (8.7%)
Less corrupt	1 (2.9%)	4 (11.8%)	17 (50%)	11 (32.4%)	1 (2.9%)
<b>Knowledge if more unofficial payments will be needed</b>					
More corrupt	0 (0%)	2 (8.7%)	10 (43.5%)	8 (34.8%)	3 (13%)
Less corrupt	3 (8.2%)	9 (26.8%)	8 (23.6%)	12 (35.5%)	2 (5.9%)
<b>Knowledge if service will be delivered after an unofficial payment</b>					
More corrupt	0 (0%)	3 (13%)	8 (34.8%)	10 (43.5%)	2 (8.7%)
Less corrupt	2 (5.9%)	5 (14.7%)	12 (35.3%)	12 (35.3%)	3 (8.8%)

Source: Author's questionnaires

Another aspect of the arbitrariness of corruption is measured by the uncertainty that whether or not after making an unofficial payment the service will be delivered as agreed (Doh, et al., 2003). As presented on Table 12, managers of MNEs from highly corrupt countries may have developed knowledge in their home country of how to



deal with corruption and use such knowledge to cope with corruption abroad. Managers of MNEs from more corrupt countries expressed that they had knowledge of whether or not a service was going to be delivered after making an illegal payment to a Guatemalan official at a rate of 52.2%. On the other hand, managers from MNEs with lower levels of corruption said that they had knowledge in this regard at a 44.1%.

Table 16 shows the result of the analysis of the influence of arbitrary and pervasive corruption on FDI to Guatemala at the firm level. Model 7 presents the results of the analysis of MNEs with headquarters in countries with lower levels of corruption than Guatemala and how they are affected by arbitrariness and pervasiveness in the host country. As presented in Table 8, MNEs from countries with lower corrupt levels than a host country with high corruption have knowledge of the pervasiveness of corruption in Guatemala. However, model 7 also shows that MNEs from less corrupt countries than Guatemala do not have knowledge about how to cope with the arbitrariness of corruption in the host country.

Table 17: Multinomial Logistic Regression of Arbitrariness and Pervasiveness in Guatemala 2007-2012

<b>Variable (Coefficient)</b>	<b>Model 7 (Less Corrupt)</b>	<b>Model 8 (More Corrupt)</b>
Intercept	57.283 (5.806)*	39.393 (2.189)*
Knowledge of price of unofficial payments	62.378 (10.900)*	37.638 (0.434)*
Knowledge if more unofficial payments will be needed	54.933 (3.455)	40.508 (3.304)*
Knowledge if service will be delivered after an unofficial payment	57.730 (6.252)	40.465 (3.261)**
<b>Model Fit</b>		
Deviance (-2 log likelihood)	51.478 (21.064)*	37.204 (10.874)*

Cox and Snell	0.401	0.377
Nagelkerke	0.430	0.409
McFadden	0.189	0.187
N	34	23

Significance levels: \*, \*\*, and \*\*\* denote significance of 10%, 5% and 1% respectively

Table 16 also presents how the arbitrariness and pervasiveness of corruption in Guatemala affects the attraction of FDI from firms from countries with higher corruption levels than the host country. Model 8 shows that MNEs from countries with higher corruption levels than Guatemala as well as MNEs from countries with lower levels of corruption, have advance knowledge of how much an unofficial payment will be (pervasiveness) in the host country, and therefore, this knowledge has a positive effect on FDI at  $p < 0.10$ . MNEs from more corrupt countries than Guatemala, however, have an advantage over their counterparts from countries with lower levels of corruption when dealing with the arbitrariness of corruption in the host country. Model 8 presents that FDI to Guatemala from MNEs headquartered in countries more corrupt than the host country is positively affected with statistical significance ( $p < 0.10$ : knowledge if additional payments need to be made;  $p < 0.01$ : if the service will be delivered) by the arbitrariness of corruption in the host country.

High corruption levels in the host country are also believed to have an effect on the entry mode and strategy used by foreign MNEs penetrating a new market. Table 17 shows that MNEs from firms located in countries with lower corruption levels than Guatemala expressed that their entry mode was affected by the level of corruption of the host country at a 26.2% rate; whereas the high level of corruption of the host country affected their strategy in the host country at an 8.8% rate. On the other hand, MNEs from countries with a higher level of corruption than Guatemala expressed that the corruption of the host country affected their entry mode and strategy used to penetrate the Guatemalan market at a 4.3% rate each.

Table 18: Corruption, Entry Mode and Strategy in Guatemala from 2007-2012

Corruption, Entry Mode and Strategy when Investing in Guatemala					
	Not at all	No	Neutral	Somewhat yes	Yes
<b>Level of corruption affected the entry mode to Guatemala</b>					
More corrupt	12 (52.2%)	10 (43.5%)	0 (0%)	1 (4.3%)	0 (0%)
Less corrupt	5 (14.7%)	14 (41.5%)	6 (17.6%)	7 (20.6%)	2 (5.6%)
<b>Level of corruption affected strategy</b>					
More corrupt	12 (52.2%)	10 (43.5%)	0 (0%)	1 (4.3%)	0 (0%)
Less corrupt	8 (23.6%)	18 (52.9%)	5 (14.7%)	3 (8.8%)	0 (0%)

Source: Author's questionnaires

The multinomial logistic analysis performed to how corruption affects the entry mode and strategy of FDI to Guatemala is presented in Table 18. Model 10 shows that corruption does not appear to have an effect on the entry mode and strategy used by MNEs from countries with higher corruption levels than Guatemala. On the other hand, Model 9 shows that MNEs from countries with lower corruption levels than Guatemala adapt their entry mode and the strategy to penetrate the Guatemalan market. These effects over MNEs from countries with lower levels of corruption than the host country is statistically significant at a  $p < 0.01$  level.

Table 19: Multinomial Logistic Analysis Corruption, Entry Mode and Strategy in Guatemala from 2007-2012

<b>Variable (Coefficient)</b>	<b>Model 9 (Less Corrupt)</b>	<b>Model 10 (More Corrupt)</b>
Intercept	14.857 (1.009)	48.013 (0.901)
Entry Mode	29.032 (15.185)**	50.313 (3.201)
Strategy	25.817 (11.970)**	50.330 (3.218)
<b>Model Fit</b>		
Deviance (-2 log likelihood)	13.847 (17.180)**	47.112 (5.157)*
Cox and Snell	0.526	0.141
Nagelkerke	0.572	0.151
McFadden	0.295	0.056
N	34	23

Significance levels: \*, \*\*, and \*\*\* denote significance of 10%, 5% and 1% respectively

The questionnaire also included questions regarding current operations in Guatemala. The rationale for including these questions obeys to the fact that the firms selected for this study have already established operations in the country and they have to cope with the high levels of corruption in the host country in their daily operations. Table 19 presents the responses of managers regarding how corruption affects their operations in Guatemala. Managers of MNEs from countries with higher levels of corruption than the host country said that corruption is part of the business culture in Guatemala at a 62.2% rate. These managers also acknowledged having

Table 20: Corruption and Operations in Guatemala from 2007-2012

	Operating in Guatemala				
	Not at all	No	Neutral	Somewhat yes	Yes
<b>Is corruption part of the business culture in Guatemala?</b>					
More corrupt	0 (0%)	0 (0%)	8 (34.8%)	11 (47.8%)	4 (17.4%)
Less corrupt	0 (0%)	0 (0%)	1 (2.9%)	19 (55.9%)	14 (41.2%)
<b>Have you ever seen anyone in your line of business give a bribe to a member of the government elite?</b>					
More corrupt	1 (4.3%)	8 (34.8%)	5 (21.7%)	7 (30.4%)	2 (8.8%)
Less corrupt	1 (2.9%)	8 (23.5%)	8 (23.5%)	11 (32.5%)	6 (17.6%)
<b>Have you ever seen anyone in your line of business give a bribe to a legislator?</b>					
More corrupt	1 (4.3%)	6 (26.2%)	7 (30.4%)	7 (30.4%)	2 (8.8%)
Less corrupt	3 (8.8%)	10 (29.4%)	7 (20.6%)	11 (32.4%)	3 (8.8%)
<b>Have you ever seen anyone in your line of business give a bribe to a bureaucrat?</b>					
More corrupt	0 (0%)	0 (0%)	1 (4.4%)	11 (47.8%)	11 (47.8%)
Less corrupt	0 (0%)	2 (5.9%)	5 (14.6%)	11 (32.4%)	16 (47.1%)
<b>Has a member of the government elite asked you for a bribe?</b>					
More corrupt	2 (8.7%)	7 (30.4%)	10 (43.5%)	4 (17.4%)	0 (0%)
Less corrupt	1 (2.9%)	12 (35.3%)	9 (26.5%)	7 (20.6%)	5 (14.7%)
<b>Has a legislator asked you for a bribe?</b>					
More corrupt	1 (4.3%)	5 (21.7%)	10 (43.5%)	6 (26.2%)	1 (4.3%)
Less corrupt	2 (5.9%)	11 (32.4%)	8 (23.5%)	11 (32.4%)	2 (5.9%)
<b>Has a bureaucrat asked you for a bribe?</b>					
More corrupt	0 (0%)	0 (0%)	2 (8.7%)	11 (47.8%)	10 (43.5%)
Less corrupt	0 (0%)	1 (2.9%)	1 (2.9%)	11 (32.4%)	21 (61.8%)
<b>How likely is your firm to do business with the government?</b>					
More corrupt	2 (8.7%)	6 (26.2%)	7 (30.4%)	7 (30.4%)	1 (4.3%)
Less corrupt	2 (5.9%)	5 (14.7%)	16 (47.1%)	9 (26.4%)	2 (5.9%)

Source: Author's questionnaires

witnessed the bribery of members of the local government elite and judiciary system at a 39.2% rate each, and members of the bureaucracy at a 95.6%. Managers of MNEs headquartered in countries with lower corruption levels than Guatemala expressed that corruption is part of the business culture in Guatemala at a 97.1%. These managers also said that they have seen members of the government elite at a rate of 44.1%; members of the judiciary system, 41.2%; and members of the bureaucracy, 79.5%.

Table 20 also presents the answers of decision-makers of MNEs operating in Guatemala of whether a member of the Guatemalan government had requested illegal payments in order to carry out their operations in the country. Managers of MNEs from more corrupt countries than Guatemala have been requested illegal payments from the members of the government elite at a 17.4%; from members of the judiciary system, 30.5%; and from the bureaucracy, 91.3%. On the other hand, managers of MNEs from countries with lower corrupt levels than Guatemala said that the members of the government elite requested illegal payments at a rate of 35.3% in the period of 2007 to 2012. During the same period, these managers said that members of the judiciary system had requested bribes at a rate of 38.3%; and members of the bureaucracy, 94.2%. Finally, both, MNEs from countries with higher or lower corruption levels than Guatemala, expressed that their probability of doing business with the host government is 34.3% and 32.3% respectively.

In order to test how corruption in the host country affected FDI from companies already in operations in a highly corrupt host country, a multinomial logistic regression was performed. Table 20 presents that FDI from MNEs located in countries with lower corruption levels than Guatemala is positively affected and statistically significant at the  $p < 0.001$  level by the perception of giving bribes to the members of the government elite and legislators of the host country as seen in Model 11. Conversely, Model 12 shows that FDI from firms from countries with lower levels than Guatemala is positively affected with a statistical significance of  $p < 0.01$

by paying bribes to the government elite and members of the judiciary system of the host country. Furthermore, unlike FDI from firms located in countries with lower levels of corruption than the host country, FDI from firms from countries with higher corruption levels than Guatemala was positively affected by doing business with the local government.

Table 21: Multinomial logistic regression Corruption and Operations in Guatemala from 2007-2012

<b>Variable (Coefficient)</b>	<b>Model 11 (Less Corrupt)</b>	<b>Model 12 (More Corrupt)</b>
Intercept	48.053 (5.203)*	16.470 (3.548)*
Is corruption part of the business culture in Guatemala?	43.826 (0.976)	13.973 (1.211)
Have you ever seen anyone in your line of business give a bribe to a member of the government elite?	55.180 (12.330)**	13.713 (0.791)
Have you ever seen anyone in your line of business give a bribe to a legislator?	53.767 (10.917)**	15.096 (2.174)
Have you ever seen anyone in your line of business give a bribe to a bureaucrat?	45.895 (3.045)	12.998 (0.76)
Has a member of the government elite asked you for a bribe?	45.548 (2.698)	28.705 (15.784)**
Has a legislator asked you for a bribe?	59.624 (16.773)	26.465 (13.543)**
Has a bureaucrat asked you for a bribe?	46.658 (3.808)	12.988 (0.67)
How likely is your firm to do business with the government?	44.818 (1.968)	19.103 (6.340)*

**Model Fit**

Deviance (-2 log likelihood)	42.850 (48.007)**	12.922 (43.920)**
Cox and Snell	0.756	0.786
Nagelkerke	0.810	0.854
McFadden	0.520	0.609

Significance levels: \*, \*\*, and \*\*\* denote significance of 10%, 5% and 1% respectively

**5.4.1 Model Fit**

As previously mentioned, endogeneity should always be expected in a social science research; however, there are methods that can be used to reduce its effects. As presented in the results of the firm-level results, the model fit of each model does not suggest any problems with endogeneity. Finally, tests to ensure no multicollinearity was present were performed to all the models for the firm-level analysis. The VIF analysis did not suggest any problem with the data or the results. According to O'Brien (2007), a commonly accepted VIF has a value of 15; however, the author also explains that in order to be more cautious, a maximum threshold of 10 should be used. As presented in the appendix of this study, none of the models used for the firm-level analysis showed problems of multicollinearity.

**5.5 Summary of the Chapter**

The results of the macroeconomic analysis are used to answer the research question: a) How does corruption distance between home and host country affect the attraction of FDI to emerging markets? The results of this section show that the total amount of FDI flow to Latin America is deterred by corruption. However, when analysing corruption distance, countries with lower level of corruption than the host countries are negatively affected by corruption distance. On the other hand, corruption distance does not appear to have an effect on corruption when both the host and home countries are considered highly corrupt.



Firm-level data was used to answer the research question: b) Why are some foreign firms less negatively affected than others by high levels of host country corruption when investing abroad? The firm-level analysis show that managers from more corrupt countries than the host countries have an advantage when dealing with arbitrary and pervasive corruption in the host country when compared to investors from countries with lower levels of corruption. On the contrary, firms from less corrupt countries show that having subsidiaries in other Latin American countries have provided them with the knowledge of how to cope with corruption in Guatemala. Finally, while firms from more corrupt countries do not change their entry mode or strategy due to the high levels of corruption in Guatemala, the results of this study suggest that high corruption in the host country affect these aspects when the investing firm has lower levels of corruption.

## **CHAPTER SIX: KEY FACTORS RELATED TO CORRUPTION AND HOW IT AFFECTS THE ATTRACTION OF FDI**

### **6.1 Introduction**

This chapter presents an answer to the two research questions. Firstly, this section answers the question: a) How does corruption distance between home and host country affect the attraction of FDI to emerging markets? Based on a macroeconomic analysis of FDI to Latin America this study argues that corruption distance has a negative effect on FDI when the home countries have a lower level of corruption than highly corrupt host countries. Furthermore, it has been acknowledged in recent literature that corruption creates challenges to foreign investors since it may increase the costs of doing businesses abroad, as well as the risk associated with those activities (Cuervo-Cazurra, 2006). However, this perception might not be the same depending on the levels of corruption of an investor's home country.

The second section of this chapter presents a firm-level evaluation of b) Why are some foreign firms less negatively affected than others by high levels of host country corruption when investing abroad? This section evaluates if corruption and its dimensions has a similar effect on the entry mode, quality of investment, and granting of public contracts for foreign investors depending on the level of corruption of their home countries.

### **6.2 Corruption Distance and how it affects FDI to Latin America**

Scholars have devoted a great deal of attention to the study of how corruption affects the attraction of FDI reaching mixed results. The vast majority of studies conclude that corruption acts as a deterrent to FDI (Bevan, et al., 2004; Bénassy-Quéré, et al., 2007; Cuervo-Cazurra, 2006; Habib & Zurawicki, 2002). On the other hand, others have not found a relationship between these two variables or even a positive one (Wheeler & Mody, 1992; Hines, 1995; Henisz, 2000). However, this study provides

an alternative explanation of how corruption affects FDI taking into account not only corruption levels but the corruption distance between the host and home countries.

This study argues that the reason why the relation of corruption and FDI might be more complex than just analysing whether high corruption in the host country deters FDI. Instead, grounded on transaction cost and institutional theories and analysed with the aid of the OLI paradigm, this study argues that it is not the levels of corruption of a foreign location but also the distance in corruption levels between the home and host countries. Nevertheless, this argument is valid only when the host country is considered highly corrupt and the home country has lower levels of corruption. On the other hand, when the host country is perceived as highly corrupt but the home country is more corrupt, corruption distance does not seem to affect FDI.

In order to explain how corruption affects FDI this study introduces the term of ‘corruption distance’. Habib and Zurawicki (2002) found that the difference between the corruption levels between home and host countries have a negative effect on FDI. However, in their study the authors grouped all foreign investors without taking into account whether or not host countries were considered more or less corrupt than the home countries. Instead, this study argues that corruption distance does have a negative effect on FDI only when FDI flows go from home countries with lower levels of corruption than highly corrupt host countries. On the other hand, when FDI flows go from countries with higher corruption levels than highly corrupt host countries, corruption distance does not seem to have an effect on FDI.

### **6.2.1 Corruption Distance and its Effects on FDI when Home countries are Equally or More Corrupt than Highly Corrupt Host Countries**

The main finding of the macroeconomic section of this study is that that not only corruption distance but also the *direction* of corruption distance matters. Firms established in countries with high levels of corruption may not be affected by high corruption levels in the host countries. This statement is based in the low transaction

costs that firms operating in highly corrupt might incur when investing in similar environments abroad due to the knowledge developed of how to cope with high corruption. Also, despite the hostility that a highly corrupt foreign location might represent, firms with experience operating in such environments might have an advantage over those firms without such expertise (Cuervo-Cazurra & Genc, 2008). The explanation for this is that MNEs from highly corrupt countries face less liability of foreignness when they deal with a weak institutional environment at home and thus can deal with similar conditions abroad and minimise their transaction costs.

Even though measuring corruption across countries is a difficult endeavour, corruption reflects a fundamental institutional framework and hence, corruption and its forms can be correlated among different locations (Svensson, 2005). Therefore, it may not be surprising that MNEs located in countries with high levels of corruption are not negatively affected by high levels of corruption abroad. This claim can be sustained by the fact that firms operating in highly corrupt countries have internalised knowledge of how to deal with corruption abroad. Also, these firms might not face pressures at their home country to not engage in corrupt deals abroad.

Based on the transaction cost perspective, this study argues that FDI from MNEs based in countries with higher levels of corruption than an already high corrupt foreign location. This argument is grounded on the premise that not all foreign investors face the same costs of engaging in corruption abroad (Montiel, et al., 2012). Firms from less corrupt countries than the host country might incur in higher costs of operating in highly corrupt countries not only to adapt to the local environment but also due to any damage that their image might experience if they engage in corrupt deals or do business in highly corrupt foreign locations (Terlaak, 2007). On the other hand, those firms that already operate in highly corrupt locations may not face such public image costs.

The institutional environments of the host and home countries also have an effect on how corruption affects FDI. According to Egger and Winner (2005), corruption is

determined by the institutional environment of a given country, which has been argued to be an important factor for a location's attractiveness (Xu & Shenkar, 2002). Therefore, the level of corruption of a foreign location can be a predictor of FDI flows to such location (Aizenman & Spiegel, 2006). However, in mainstream literature the levels of corruption have been portrayed as deterrent of FDI. Moreover, high levels of corruption are also associated with an unfavourable institutional environment (Egger & Winner, 2005). Nevertheless, this study argues that corruption itself might not be what deters foreign investors but the uncertainty it creates. Moreover, this uncertainty can be exacerbated due to the difference in levels of corruption between a home country with lower levels of corruption than a highly corrupt host country. Therefore, certain foreign investors with different institutional home environments might actually be deterred by high corruption in the host country, while those with similar institutional environments are not.

### **6.2.2 Corruption Distance and its Effects on FDI when Home countries are Less Corrupt than Highly Corrupt Host Countries**

The results of this study indicate that corruption distance has a negative effect on FDI when the home country has lower levels of corruption than a highly corrupt host country. This finding is sustained by the fact that firms headquartered in countries with low levels of corruption might incur in high costs when conducting business in highly corrupt foreign locations (Cuervo-Cazurra, 2006). In fact, the costs that foreign MNEs face abroad due to corruption are very significant. According to Kwok and Tadesse (2006) corrupt payments total a significant amount of a nation's GDP. Therefore, these costs cannot be understated by foreign firms evaluating whether or not to invest in a foreign location.

Another aspect to take into account when explaining why corruption distance affects negatively FDI is the risk associated with investing in a highly corrupt foreign location. Casson and Lopes (2013) state that foreign firms entering unfamiliar environments always face risks; however, such risks, in some countries, can appear

more challenging than in others. This argument is valid in the context of corruption distance and FDI when the home country has lower levels of corruption than a highly corrupt host country. However, investment occurs in foreign locations despite of their level of corruption, which could imply that there are some firms that are better able to adapt to unfamiliar conditions than others. Therefore, in this study it is argued that when the degree of unfamiliarity with the host country environment is greater, FDI is affected negatively. In other words, the greater the corruption distance between a home country with lower levels of corruption than a highly corrupt host country the more negative effect such distance has on FDI.

### **6.2.3 Corruption and its Effects on FDI**

In line with the extant literature about corruption and FDI, this study argues that corruption deters overall FDI to Latin America. This argument is consistent with the extant relevant literature of corruption and FDI. The theoretical basis against corruption are derived from transaction costs and ethics (Habib & Zurawicki, 2002), since foreign investors might be deterred to invest in highly corrupt countries due to the high costs this represents, or because they believe corruption is morally wrong. As previously presented, the majority of FDI flows to Latin America originate in developed economies, which generally have low levels of corruption, according to Transparency International (Transparency International, 2011). Therefore, when investing in a location characterised as highly corrupt, such as Latin America, it is understandable that such high levels of corruption deter FDI flows to the region.

The rationale behind the argument of why corruption deters FDI is due to the fact that high corruption in the host country can be difficult to manage, costly, and risky (Casson & Lopes, 2013). Therefore, the negative effect of corruption on FDI flows to Latin America found on this study implies that foreign investors, as a whole, are deterred by high corruption in the host country. However, this study not only corroborates that high levels of corruption have a negative impact in FDI as a whole, but also does so with an innovative methodology.

Most studies analysing corruption and FDI have taken an econometric approach but have utilised only cross-sectional data such as Habib and Zurawicki (2002) and Cuervo-Cazurra (2006). Instead, this research utilised panel data for the analysis. Also, studies analysing how corruption affects the attraction of FDI have not taken into account the level of corruption of the host countries as compared to corruption levels of the home countries. Habib and Zurawicki (2002) analysed the interaction between home and host country corruption but they did not make a distinction between home countries with higher or lower corruption levels than the host countries. On the other hand, Cuervo-Cazurra (2006) demonstrated that those firms that had signed the OECD Anti-Bribery convention are deterred by corruption abroad; however, with this distinction countries considered as highly corrupt (such as Mexico) were grouped with countries with low levels of corruption (such as Finland). Therefore, even if this study confirms that FDI, as a whole, is deterred by corruption abroad, it does so with an innovative method.

#### **6.2.4 Analysing Corruption Distance with the OLI Paradigm and Institutional Theory**

This study utilised a combination of the TCT and institutional theory with the OLI paradigm as a framework to analyse how corruption distance affects FDI. Nevertheless, it is important to reiterate that the OLI paradigm is context-specific and that its elements cannot be analysed in an isolated manner (Stoian & Filippaios, 2008). However, Brouthers, et al., (1999) argue that the OLI paradigm may be more appropriate to analyse FDI activities than transaction costs along. Among the ownership ‘O’ specific advantages of firms internationalising scholars have identified advantages inherent to the firm that allows it to begin operations in foreign markets. Based on this premise this study suggests that one ‘O’ advantage that firms located in highly corrupt countries is that they have acquired knowledge of how to deal with corruption at home and have exploited such knowledge abroad. On the other hand, firms that have not acquired and internalised knowledge of how to deal with corruption at home are deterred by high levels of corruption abroad.

The results of this study suggest that once a firm located in a highly corrupt country has acquired knowledge of how to cope with corruption at home, this 'O' specific advantage can be exploited abroad. In other words, the intangible knowledge generated regarding how to cope with corruption at home has been internalised to be exploited in other highly corrupt locations. Nevertheless, MNEs headquartered in countries with low levels of corruption may have not generated such knowledge, and therefore, they may struggle to adapt to generate the knowledge to cope with high levels of corruption abroad.

The third part of the paradigm has to do with the location of FDI abroad. As previously described the L advantages play an important part of the analysis of foreign markets since they can define whether or not such markets are attractive (Dunning, 1998). Furthermore, scholars have acknowledged that L specific advantages are different for different companies and even for different projects (Brouthers, et al., 1999). Therefore, this study argues that it is not only the presence of corruption in a foreign location what deters FDI. Instead, corruption in a foreign location may impact FDI depending on whether or not foreign investors experience high levels of corruption at home. Finally, this study argues that when analysing FDI activities to highly corrupt locations, scholars should not only include corruption levels of the host countries, but also the corruption distance between them and whether or not home-countries have higher or lower levels of corruption than the host countries.

One of the most important factors to take into account when choosing a foreign location to establish operations is the institutional environment of such location (Wu, et al., 2008; Orr & Scott, 2008). According to Cantwell, et al., (2010), MNEs must adjust their strategies and structures to respond to uncertainty in a foreign environment. Furthermore, the institutional environment of a foreign location can determine the attraction of foreign investment since a good institutional environment may raise the productivity of foreign MNEs (Bénassy-Quéré, et al., 2007). However,



a poor institutional environment abroad might increase the costs of operating in that location and thus deter FDI (Bénassy-Quéré, et al., 2007).

Nevertheless, building on the premise that not all foreign investors are equal (Cuervo-Cazurra, 2006), and that some firms have internalised the knowledge of how to cope with corruption at home, this study argues that even though corruption increases uncertainty, this uncertainty is not the same to all foreign investors. Therefore, this study argues that the corruption level on its own is not enough to explain why corruption deters FDI. Instead, what might deter FDI is the uncertainty caused by corruption distance between a host country with high levels of corruption and a home country with lower corruption levels. On the other hand, those firms located in highly corrupt countries might not be affected by high corruption abroad since they are used to operating in similar situations.

### **6.3 Firm-Level Analysis of Corruption and its Effects on FDI**

This section analyses the answer to the research question: Why are some foreign firms less negatively affected than others by high levels of host country corruption when investing abroad? To do so, a firm-level analysis of how high levels of corruption abroad affect foreign investors was conducted. Firstly, in-depth semi-structured interviews were conducted. Secondly, based on the responses to the interviews a questionnaire was developed to reach at a larger respondent sample to better understand the issue.

#### **6.3.1 Motives of FDI and how they are Affected by Corruption**

The motives of FDI have been widely discussed in IB literature. As mentioned before, Dunning (1998) identified three main motives for FDI which are: Foreign-market-seeking; efficiency-seeking; and resource-seeking. However, this study did not find that one motive for FDI to Guatemala was preferred over another due to the corruption levels of the country. At the same time, the choice of JVs or WOS as entry mode did not have an effect on FDI to the country. However, having previous

presence in other Latin American countries had a statistical significance as a motivation of FDI from countries with lower levels of corruption than Guatemala. These results may suggest that firms with lower levels of corruption than Guatemala needed to acquire knowledge of how to cope with a weak institutional environment in Latin America before deciding to enter the Guatemalan market. However, firms from more corrupt countries did not need to acquire knowledge to cope with corruption in a foreign location because they had acquired such knowledge at home.

### **6.3.2 Types of Corruption in Guatemala and their Effect on FDI**

The three types of corruption that can be found in a democracy (in the bureaucratic, judiciary, and government elite sectors) did not present a significant effect on FDI from either more or less corrupt countries than Guatemala. Even though Guatemala is perceived as highly corrupt (Transparency International, 2010), none of these types of corruption seem to affect the attraction of FDI to the country. One possible explanation is provided by one of the foreign managers interviewed for this study. According to the respondent, ‘the high levels of corruption in Guatemala are not a secret to any foreign investor.’ Therefore, once the decision of investing in Guatemala has been made, it is unlikely that high corruption in any of the three main sectors of the public sphere of the country have a strong effect on foreign investment.

### **6.3.3 Arbitrariness and Pervasiveness of Corruption and FDI to Guatemala**

Literature on corruption and FDI presents arguments for a negative impact on corruption on FDI and a positive one. Recently some scholars have argued that the reason why there is no consensus regarding corruption and its effect on FDI is due to the fact that corruption does not have the same characteristics in different countries (Cuervo-Cazurra, 2008; Uhlenbruck, et al., 2006). Based on two dimensions of corruption, arbitrariness and pervasiveness, Cuervo-Cazurra (2008) concludes that both types of corruption deter FDI. However, according to Cuervo-Cazurra (2008), arbitrary corruption has a negative lesser effect on FDI because it just becomes a part

of the uncertainty of operating abroad, while pervasive corruption increases the known costs of operating in a highly corrupt country.

Building on Cuervo-Cazurra (2008), this study furthers the knowledge regarding the arbitrariness and pervasiveness of corruption. This study presents evidence that firms headquartered in highly corrupt countries may be better prepared to cope with the arbitrariness of corruption abroad because they have acquired knowledge of how to cope with that dimension of corruption at home. On the other hand, firms without such knowledge are deterred by the uncertainty caused by arbitrary corruption abroad.

According to Cuervo-Cazurra (2006), pervasive corruption, corruption that is generally present, deters FDI because it increases the *known* costs of investing in a highly corrupt location. This study confirms that firms operating in Guatemala have a good knowledge of the known costs associated with corruption; therefore, firms from an either more or less corrupt home country than Guatemala are not deterred by high corruption in the host country.

When analysing arbitrary corruption, however, firms headquartered in countries with higher corruption levels than Guatemala seem to have an advantage over their counterparts based in countries with lower levels of corruption. Based on the responses from foreign investors in Guatemala, this study argues that arbitrary corruption has a positive effect on FDI to Guatemala when the home country is more corrupt than the host country. Therefore, explaining why high levels of corruption in the host country may not deter foreign investors from highly corrupt home countries.

This is an important finding because it helps explain why firms headquartered in highly corrupt countries might not be deterred by high levels of corruption in a foreign location. Based on this premise, this study proposes that firms based on highly corrupt countries have acquired knowledge not only about the known costs of corruption abroad, but also regarding whether or not extra payments will be needed or if the service will be delivered as promised. This result addresses a gap in the

current literature by empirically demonstrating why firms from highly corrupt countries might not be deterred by high corruption abroad.

#### **6.3.4 Entry Mode**

While there are a growing number of studies analysing corruption and its effect on FDI, the relationship between corruption and entry mode has not received the same level of attention (Duanmy, 2011). This study addresses this lack of empirical analysis in the area of corruption and its effects on entry mode at the firm-level. This study argues that companies did not choose to invest in the country based on the option of selecting JVs or WOS. However, when analysing how the high levels of corruption in Guatemala affected the entry mode chosen the results are different. While firms located in countries with higher corruption levels than Guatemala did not modify their entry strategy to the country due to the corruption levels of the host country, firms from less corrupt countries did.

According to managers with investments in Guatemala, the high levels of corruption in the host country motivated them to opt for a WOS to enter the country. Scholars have argued that high levels of corruption in the host country will lead foreign investors to choose JVs over WOS in order to minimise risk (Smarzynska & Wei, 2000). However, other studies have found the opposite. These studies actually argue that that MNEs would prefer to enter highly corrupt foreign locations via WOS in order to avoid collaborating with highly corrupt local companies, and to maintain greater control of their operations abroad (Uhlenbruck, et al., 2006; Duanmy, 2011).

This study, however, separated foreign investors according to the level of corruption of their home countries. The results of the study suggest that firms with lower corrupt levels than Guatemala would prefer WOS over JVs when investing in a highly corrupt foreign location in order to exert control over their operations. This result can be explained because in long-term contracts, such as FDI, greater asset specificity increases the costs of contracting (Williamson, 1996); therefore, in order to avoid such costs, an MNE will prefer to internalise its operations if it perceives a foreign

location as too risky. On the other hand, corruption did not have an effect on the entry mode chosen by foreign investors from more corrupt countries. According to managers interviewed, corruption did not dictate their entry mode but instead the costs of establishing foreign subsidiaries did.

### **6.3.5 Quality of FDI and Corruption**

This study also researched the *quality* of investment and how this was affected by high levels of corruption in the host country. According to Zurawicki and Habib (2010), it is necessary to investigate not only whether or not corruption in the host country decreases the level of investment but also if corruption decreases its quality. The results presented in this study suggest that the quality of FDI from more corrupt countries than Guatemala was not affected by the high levels of corruption of the host country. On the contrary, the quality of FDI from firms located in countries with lower levels of corruption was affected by the high levels of corruption of the host country. Based on the data gathered in this study, firms from less corrupt countries argued that their investment in Guatemala was mainly devoted to projects that could be easily relocated abroad if needed. Furthermore, these investors argued that due to the uncertainty created by high levels of corruption they would not make substantial investments in the country such as R&D centres or plants for highly skilled workers.

### **6.3.6 Operating in Guatemala after the Decision of Investing has been made**

Institutional theory proposes that MNEs encounter a contradictory situation when attempting to gain legitimacy in the different markets on which they operate (Kostova & Zaheer, 1999). Furthermore, Kostova and Zaheer (1999) argue that headquarters often exert pressure to their foreign subsidiaries to resemble practices established at home when operating abroad. However, managers might resist such pressure if they believe that the practices imposed by headquarters go against local beliefs (Kostova & Zaheer, 1999). Based on this premise, this study seeks to understand if firms headquartered in countries with higher levels of corruption face

similar pressures to not engage in corruption abroad than their counterparts headquartered in countries with lower levels of corruption than the host country.

In their study, Kostova et al., (2008), suggest that due to their foreignness, MNEs may be protected from pressures to adapt to host country institutions. However, in the corruption area, Spencer and Gomez (2011) found evidence that MNEs face pressures to adapt to host country expectations and conventions. However, the results from Spencer and Gomez (2011) may be derived from the fact that they did not separate foreign investors based on their level of corruption as compared to the corruption level of the host country. For this reason, to shed light into the debate of how foreign firms cope with the pressure to engage in corruption in the host country, this study focuses on the different pressures foreign firms face. Thus, this study analyses firms from either more or less corrupt home countries than a highly corrupt country and how they cope with pressures to adapt to local corrupt conventions in the host country.

Based on the results of the questionnaires handed to foreign investors with presence in Guatemala, this study found that firms from more corrupt countries might have an advantage when operating in a highly corrupt foreign country because they possess knowledge of how to conform to the local conventions of the host country. According to foreign managers of MNEs based in more corrupt countries than Guatemala, members of the government elite and of the judiciary system have requested them illegal payments to operate in the country. Furthermore, these managers also expressed that they do business with the local government in a regular basis. Therefore, it could be implied that these firms have knowledge of how to deal with corruption abroad, and they are not concerned regarding the damage that their reputation might suffer for doing so.

On the contrary, firms based in less corrupt countries than a highly corrupt country might not totally conform to local pressures to adapt to high levels of corruption. Even though the results of this study suggest that firms from less corrupt countries

may make illegal payments to local members of the government elite and of the judiciary system, they expressed that they try to avoid doing business with the local government. This result might suggest that even though firms from less corrupt countries do participate in corrupt deals, their involvement does not have the same magnitude than those of firms from more corrupt countries than a highly corrupt host country. Therefore, a possible explanation of why firms from highly corrupt home countries are not affected by high levels of corruption in the host country might be that they have less pressure from headquarters to not engage in corrupt deals.

#### **6.4 Summary of the Chapter**

Corruption and its effect on FDI have been widely studied in recent literature reaching very different results. While some authors have found a strong negative effect of corruption on FDI others have found no effect or even a positive one. For this reason, this study analyses the issue of corruption and FDI from a different perspective, which is whether the distance on corruption levels between host and home countries have a greater effect on FDI than just the corruption levels of the host location. Therefore, this research proposes the following research question: a) How does corruption distance between home and host country affect the attraction of FDI to emerging markets?

In order to further the knowledge regarding corruption and its relation with FDI, this study suggests that it is not only the levels of corruption of a foreign location what might affect the attraction of FDI but the distance of corruption levels between a home and host country. In addition to corruption distance, this study also suggests that the direction of such distance is important when analysing how corruption affects FDI. The rationale behind this claim is because when analysing FDI flows from countries with lower levels of corruption than a highly corrupt host region, the higher the distance the greater negative effect it has on FDI. On the other hand, corruption distance does not seem to have an effect on FDI when the home country has higher levels of corruption than an already highly corrupt host region.

This study also analysed how corruption affected foreign investors at the firm level in order to answer the following research question: b) Why are some foreign firms less negatively affected than others by high levels of host country corruption when investing abroad? To answer this research question, this study took into account how the high levels of corruption of Guatemalan public officials affected foreign investors. The results show that corruption amongst bureaucrats, judges, and members of the government elite do not seem to have an impact on the decision making process of allocating FDI in the country because foreign investors are aware of the problem.

Moreover, one of the reason why FDI from firms located in highly corrupt countries might not be deterred by high levels of corruption abroad is because they may possess knowledge of how to cope with the arbitrariness of corruption. On the other hand, this study suggests that firms from countries with lower levels of corruption than Guatemala might struggle with the arbitrariness of corruption in the host country.

High corruption levels in the host country seem to have an effect on the entry mode utilised by firms from countries with lower levels of corruption. Based on the results presented on this study, MNEs from less corrupt countries might opt to enter a highly corrupt host country via WOS. This might be explained by the fact that these investors prefer to have more control over their firms' operations in a highly corrupt country. Also, these managers need to protect their image and not to be associated with local partners that are perceived as corrupt.

Recent literature has also questioned if high levels of corruption in the host country affect the *quality* of FDI received by a host country. According to the responses of firms operating in Guatemala, the quality of FDI is affected by corruption when the home country is less corrupt than the host country. Managers of firms headquartered in countries with lower level of corruption than Guatemala expressed that their investment would not include state-of-the-art plants, or R&D facilities due to the high risks associated with corruption in the country. On the other hand, the quality



FDI from more corrupt countries than Guatemala was not affected by the high levels of corruption of the host country.

Finally, another reason why firms based on more corrupt countries than Guatemala might not be deterred by the levels of corruption of the host country is their relationship with the local government. Even though this study presents evidence that managers from MNEs based in both more or less corrupt countries than Guatemala might participate in corrupt deals, managers from more corrupt countries admitted to conduct businesses with the local government.

## CHAPTER SEVEN: CONCLUSIONS

The aim of this thesis, as mentioned in Chapter 1, was to analyse how corruption affects the attraction of FDI to a highly corrupt foreign location. In order to do so, the thesis proposed two questions to be answered: a) How does corruption distance between home and host country affect the attraction of FDI to emerging markets? And B) Why are some foreign firms less negatively affected than others by high levels of host country corruption when investing abroad? Emulating the vast majority of studies dealing with this issue, the first section attempted to understand how corruption affected the attraction of FDI to a highly corrupt foreign location at the macroeconomic level. The aim of this section was to understand whether or not FDI flows were affected by corruption in the same manner of the home country experienced higher or lower corruption levels than the host region.

The second section of this study, on the other hand, was concerned with the analysis of how corruption affects the decision-making process of investing in a highly corrupt foreign country, and how corruption affected subsequent operations in that location at the firm level. The aim of this section was to understand which factors related with corruption abroad affected decision-makers when deciding to invest in a highly corrupt foreign location and to compare those answers based on the level of corruption of the home country.

This chapter will study the theoretical contributions made by this thesis, which concentrate mainly in recognising that when analysing how corruption affects the attraction of FDI it is not only the corruption level of the host country what matters but the interaction of the corruption levels of the home and host country. Furthermore, this study contributes to the knowledge of how corruption affects FDI by arguing that the level of corruption of the home country as compared to the host country will have an effect on FDI flows. This chapter will then provide recommendations for practitioners in order to apply the new knowledge developed.

Finally, this chapter ends with an evaluation of the thesis followed by suggestions for future research.

### **7.1 Theoretical Contribution**

This study contributes to theory in a number of ways. The first section of the study makes contributions that can be classified under several key findings in relation to applicability of the study of corruption and its effects on FDI. The first contribution is the applicability of the TCT and institutional theories integrated to study how corruption affects FDI. The second contribution is the applicability that this research offers by integrating TCT and institutional theory with the help of the OLI paradigm. The third area shows the importance of taking into account the role of the corruption level of the home country as well as of the host country when analysing corruption and how it affects the attraction of FDI. The fourth area is the finding that when analysing FDI to a highly corrupt foreign location, it is important to take into account whether or not the home country has higher or lower corruption levels than the host country. Finally, this study contributes to the knowledge of corruption and its effect on FDI by stating that the corruption level of the home country alone may not deter FDI. Instead, this study argues that it is the uncertainty and the pressures faced at home that this corruption levels create what may deter FDI for those foreign investors not used to dealing with corruption in their home countries.

The second section of the study also contributes to theory about how corruption affects the attraction of FDI but focused at the firm level. The key contributions of this section are, firstly, that when analysing corruption and its effect on FDI, it is important to distinguish the levels of corruption of the home country as compared to the host country. Secondly, this study argues that firms based in highly corrupt home countries might be better prepared to cope with the different dimensions of corruption of the home country based on the experience acquired at home. Thirdly, it is necessary to analyse whether or not firms have different pressures to comply with

home and host country expectations related to corruption in the host country based on the corruption levels of the home country.

## **7.2 Applicability of TCT and the OLI Paradigm to Research Context**

When analysing how corruption affects the attraction of FDI at the macroeconomic level, the transaction cost theory and the OLI Paradigm are two well recognised standpoints that help to analyse the issue. However, the perspectives provided by these theories seem to offer opposing explanations of organisational occurrences. As previously mentioned, Granovetter (1985) says that the TCT provides an *undersocialised* account of MNEs' activities. On the other hand, Roberts and Greenwood (1997) claim that the OLI Paradigm includes a socialised account of the process of FDI allocation, and thus, these frameworks can offer complementary elements in order to analyse issues affecting the MNE.

While analysing how corruption affected the decision-making process of investing and operating in a highly corrupt host location, an including an institutional framework within the OLI Paradigm was selected as a more appropriate method. Building on Kostova and Zaheer (1999) this study argues that MNEs face pressures to adapt to the host location institutional environment while maintaining legitimacy at home. However, this study furthers this notion by stating that those foreign firms located in highly corrupt home countries face less pressures from headquarters to not engage in corrupt deals abroad, when compared to their counterparts headquartered in less corrupt countries.

## **7.3 Increased Applicability Due to the use of TCT and the OLI Framework**

While both the TCT and the institutional theory have provided an answer of how corruption affects the attraction of FDI, each face shortcomings to fully explain this phenomenon. As previously mentioned, the TCT offers an explanation based only on the costs that a firm might incur when operating abroad, while the OLI that includes the institutional theory provides a socialised account of the issue. For this reason, this

study integrated the TCT and OLI paradigm to provide a better picture of how corruption affects the attraction of FDI to a highly corrupt foreign location.

The method chosen for using the TCT and the OLI paradigm. Based on the OLI paradigm this study argues that firms might develop knowledge (O advantages) of how to cope with a highly corrupt foreign environment. Also, this study proposes that such knowledge can be internalised and exploited in foreign countries experiencing high levels of corruption. This argument is based on Dunning's work that states that O advantages can compensate for additional costs that an MNE may incur with starting operations abroad that may not be faced at home (Dunning, 1988). Thus, to account for these variables this study utilises not only the corruption level of the host country, but also the corruption level of the home country. Moreover, the difference in corruption levels is used to account for the unfamiliarity that an MNE might have with a highly corrupt foreign location. Nevertheless, this study also differentiates between home countries with higher or lower corruption levels than the host countries, in order to evaluate if these firms have developed different knowledge regarding how to cope with corruption abroad.

The I-specific advantages part of the OLI paradigm studies why an MNE would choose to own and operate a facility in a foreign country as opposed to servicing such market in other manner (Anderson & Gatignon, 1986). The internalisation theory, therefore, proposes that MNEs will choose a low level of control to service a foreign market unless the transaction costs related with such operations are considered too high. However, this study argues that different foreign investors perceive different risks differently depending on the environment on which they operate at home. Therefore, if a firm has developed an O specific advantage of knowing how to deal with corruption that a firm may internalise and exploit such knowledge in other highly corrupt foreign locations. Conversely, MNEs without such O-specific advantage might avoid investing in highly corrupt foreign markets.

This study also integrated institutional theory to the L section of the OLI paradigm to analyse how corruption affects FDI. As stated before, poor institutions may increase cost in the search, negotiation and enforcement of contracts abroad, and hence, these conditions may deter FDI to certain locations (Meyer, 2001). Nevertheless, institutions alone may not completely explain dissimilarities in the variation of FDI to foreign locations (Pournarakis & Varsakelis, 2004). Instead, FDI decisions involve an assessment of the foreign market and institutions seen from the investing company vantage point. Therefore, this study argues that the corruption levels of the foreign location matter as determinants of FDI but when compared to corruption levels of the home country.

#### **7.4 Applicability of the OLI Paradigm to Analyse how Corruption Affects the Attraction of FDI at the Firm Level**

While the first part analysed how corruption affected the attraction of FDI to Latin America in a macroeconomic manner, it is important to note that a firm level analysis was also needed to provide a better explanation of the issue. Grounded on the OLI paradigm and by including an institutional aspect to it, this study argues that the level of corruption of the home country as compared to the host country is an important factor to take into account when analysing how corruption affects the attraction of FDI. The results of this section suggest that MNEs from home countries with lower levels of corruption than a highly corrupt host country might struggle with the arbitrariness of corruption in the host country. This result can be explained due to the lack of experience that some firms located in countries with lower levels of corruption than a highly corrupt host country have in dealing with arbitrariness of corruption.

This study also suggests that high levels of corruption in the host country may to have a direct effect on the entry mode utilised by firms from countries with lower levels of corruption. Based on institutional theory this study argues that MNEs from less corrupt countries might opt to enter a highly corrupt host country via WOS. This

might be explained by the fact that these investors prefer to have more control over their firms' operations in a highly corrupt country. Furthermore, these MNEs need to protect their public image and therefore, they might avoid being associated with local partners that are perceived as corrupt.

Based on institutional approach this study also sheds light on the issue of whether or not high levels of corruption have an effect on the quality of FDI received by a highly corrupt host country. In line with the rest of this study, investing countries were separated as home countries with either more or less corruption levels than the host country. The results presented suggest that firms headquartered in countries with lower level of corruption than a highly corrupt host country would not include state-of-the-art plants, or R&D facilities due to the high risks associated with corruption in the host country. Therefore, diminishing the quality of their investment allocated abroad due to the levels of corruption of the host country. On the contrary, the quality FDI from more corrupt countries than the host country does not seem to be affected by the high levels of corruption of the host country.

Finally, the results of this study argue that all foreign investors with presence in a highly corrupt host country face pressures to conform to local business practices. However, those firms based in countries with higher levels of corruption than the host country might incur in more corrupt deals than their counterparts from less corrupt countries. This result suggest that the pressures of not participating in corrupt deals might be stronger for those firms located in home countries with lower corrupt countries than the host country. On the other hand, MNEs located in highly corrupt home countries might not face strong pressures to not engage in corrupt deals abroad.

### **7.5 Extending TCT and OLI paradigm**

One more contribution resulting from utilising the TCT and the OLI paradigm was the extension of the literature in the IB discipline. The TCT theory was extended by arguing that firms that had acquired knowledge about coping with corruption at

home can internalise such knowledge and exploit it in other highly corrupt markets. Therefore, this argument means that firms with knowledge about dealing with corruption at home can minimise the costs associated with corruption abroad. On the other hand, the OLI paradigm was extended by stating that the corruption levels *per se* might not be fundamental in the decision-making process of allocating FDI. Instead, including an institutional environment to the L part of the paradigm in a foreign location should include an analysis of the distance between the institutional environment of the home and host countries and how this distance affects the decision to invest abroad.

### **7.5.1 Role of Corruption Distance as Determinant of FDI**

This study analysed how corruption affected the attraction of FDI for host locations with high corruption levels. One of the most important contributions of the study is the introduction of the term ‘corruption distance’. Based on the results of the study, it is argued that the difference in levels of corruption of the home and host countries have an effect on the attraction of FDI to a highly corrupt host location. Furthermore, this study also argues that it is not the difference levels of corruption what affects FDI but also its direction.

In order to analyse how corruption distance and its direction affected the attraction of FDI to developing economies, this study separated home countries as either more or less corrupt than the host country. This distinction was made in order to analyse whether or not firms from each set of countries react differently to corruption in the host country. The results suggest that corruption distance has a negative effect on FDI from when the home countries experience lower levels of corruption than the host countries. On the other hand, firms from highly corrupt countries were not affected by corruption distance when investing in the area.

Therefore this study proposes that when analysing determinants of FDI the corruption levels of the home and host countries should be taken into account. Also,



in order to obtain a better picture of the issue at hand, when analysing how corruption affects FDI flows to developing markets, a ‘corruption distance’ variable should be utilised.

### **7.5.2 Role of Corruption in the Decision-making Process and Subsequent Operations in a Highly Corrupt Host Country**

While analysing how corruption affects the decision making process of investing and subsequent operations in a highly corrupt country this study found that the institutional environment of the home country could dictate how foreign firms operate in the host country. Firstly, the corruption level of the home country would have a direct effect on whether or not a foreign company penetrates a highly corrupt host country via WOS or a JV, if the home country has lower levels of corruption than the host country. This based on the need for the company to not be associated with local partners that might be considered corrupt.

Secondly, pressures to not engage in corrupt deals differ based on the level of corruption of the home country. Firms based in countries with lower levels of corruption than a highly corrupt host country may get involved in corrupt deals; however, these firms tried to avoid direct contact with the local government. On the other hand, firms based in home countries with higher levels of corruption than an already highly corrupt host country actively engaged in business with the local government. This result may suggest that although all firms engage in some level of corrupt deals in the host country, those firms located in countries with lower levels of corruption than the host country face more pressures to not engage in corruption abroad.

## **7.6 Empirical Contributions**

This study provides empirical evidence to complement studies suggesting that firms based on countries with high levels of corruption are not affected by this issue when investing abroad. On the other hand, firms located in home countries with lower

levels of corruption than the host country are negatively affected not only by the corruption levels of the host country but also by the distance of such levels. By doing so, this study contributes to the study of how corruption affects FDI by introducing the concept of ‘corruption distance’ as an institutional determinant of FDI.

At the firm-level analysis this study also provides important empirical contributions. Firstly, this study argues that foreign firms react differently by high levels of corruption abroad depending on the levels of corruption of their home countries. Also, this study empirically demonstrates that firms with higher levels of corruption than a highly corrupt host country have developed knowledge of how to deal with arbitrary corruption in the host country, while their counterparts based in less corrupt home countries struggle to acquire such knowledge. Finally, this study also argues that all firms operating in a highly corrupt host country must adapt to the local conventions; however, those firms located in home countries with lower levels of corruption than the host country face higher pressures to not fully engage in corrupt deals than their counterparts headquartered in countries with higher corruption levels than the host country.

### **7.7 Recommendations for Policy**

This study has empirically demonstrated that in general high levels of corruption deter FDI. Furthermore, this study also demonstrated that corruption and corruption distance discourage FDI when the home country has lower levels of corruption than the host country. On the other hand, corruption and corruption distance do not affect FDI when the home country is considered more corrupt than the host country. However, the bulk of FDI activities are carried out by MNEs located in developed countries (UNCTAD, 2012), which generally have low levels of corruption (Transparency International, 2011). Furthermore, this study also demonstrated that the quality of FDI also suffers due to high levels of corruption abroad. Therefore, if local governments desire to attract more FDI and higher quality FDI into their countries, their efforts should be concentrated in reducing their corruption levels in

order to decrease the corruption distance with the home countries of potential foreign investors.

### **7.8 Recommendation for Management Practice**

Taking into account the difference in corruption levels of the home and host countries into the FDI model should help MNEs recognise the importance of this factor in the selection of a foreign location on which to conduct operations. Furthermore, in today's business environment considering not only the corruption levels of the host country but the distance of these levels when compared to the home country will help managers in the process of assessing possible foreign locations where to invest. Therefore, when MNEs establish the importance of corruption distance for FDI allocation, their response to the estimated improvement or deterioration in the host country levels of corruption would have to be programmed (Habib & Zurawicki, 2002).

However, high levels of corruption are important not only to decide whether or not to invest in a foreign location. Instead, corruption levels will have a permanent effect on the daily operations of a company in a foreign country. Therefore, managers should also take into account the levels of pervasive and arbitrary corruption before and after the decision of investment has been made. Also, specific guidelines of how to react to high levels of corruption abroad should be in place in order to minimise corporate damage inflicted by engaging in corrupt practices abroad.

### **7.9 Evaluation of the Study**

The importance of the theoretical contribution of this study rests on furthering knowledge regarding how corruption affects the attraction of FDI depending on the interaction between home countries with host countries considered highly corrupt. Also, this study utilises a combination of TCT and the OLI Paradigm in order to avoid an oversocialised or undersocialised account of the issue. In the first section of this study it is demonstrated that it is not only the levels of corruption of the host

country what deters FDI. Instead, the distance of the corruption levels between the home and host countries, when the home country has lower levels of corruption, are responsible for the negative influence of corruption on FDI flows. However, the macroeconomic section of this study does not provide an explanation of why foreign investors are affected differently by corruption in the host country based on the levels of corruption of their home country. For that reason, a firm-level analysis was performed.

The firm-level analysis helped clarifying and strengthening the role played by the institutional environment of the home and host countries on how MNEs deal with high levels of corruption abroad. This section of the study demonstrated that those firms located in highly corrupt home countries not only have developed knowledge of how to cope with high corruption abroad but also might not face pressures to not engage in corrupt deals in the host country. On the other hand, MNEs located in home countries with lower levels of corruption abroad might not have developed such knowledge and might face more pressures to avoid participating in illegal acts abroad.

Moreover, the theoretical contribution of this study furthers to knowledge through integrating concepts from two seemingly opposing theories with the help of the OLI framework. Therefore, this study enhances the IB literature by demonstrating that scholars do not have to choose between the TCT and institutional theory but can utilise both to perform an enhanced viewpoint to study MNEs' activities.

### **7.9.1 Generalisation**

The recommendations provided for practitioners and policy makers resulted from a generalisation to the fact that FDI from MNEs located in home countries with lower corruption levels than a highly corrupt host country is negatively affected by corruption of the host country. Based on the nature of the study it is feasible to argue that the same models can be applied to understand how corruption affects the

attraction of FDI to other highly corrupt host locations. Therefore, the conclusions provided by this research could be applied to MNEs investing in other locations with little changes to the original models.

### **7.9.2 Evaluation of the Methodological Contribution**

This study made several methodological contributions to the IB discipline. Firstly, this study utilised panel data to analyse how corruption affects the attraction of FDI to an entire region, which might provide a better picture of the issue. Secondly, this study builds on Cuervo-Cazurra (1995) and Habib and Zurawicki (2002) by taking into account not only the corruption levels of the host country but also those of the home country. However, this study separates home countries as either more or less corrupt than the host country in order to see how corruption affected foreign firms based in their level of knowledge of how to cope with corruption. Thirdly, this study also took into account not only the corruption levels of the home and host countries but also the distance in such levels to obtain a better picture of how corruption affected FDI flows to a highly corrupt foreign location.

At the firm-level this study also contributed to methodology in the IB discipline. The most important contribution is the utilisation of both quantitative and qualitative methods to understand how corruption affected not only the allocation of FDI but also the operations of foreign firms in a highly corrupt host country. The rationale to use both methods was to compensate for the weaknesses of each individual method and not to triangulate, since triangulation is not possible since both methods cannot study the same phenomena (Sale, et al., 2002). Instead, the qualitative method was utilised to provide a platform on which the quantitative method was build. Therefore, this research could be considered as the first attempt to analyse how corruption affects FDI at the macroeconomic and firm levels by using a mixed methodology.

### 7.9.3 Limitations

This study presents several limitations that result from the nature of the data presented. Due to the availability of data the macroeconomic approach only analysed FDI flows to 12 Latin American countries from 2006 to 2009. Also, the FDI flows were not disaggregated at the industry level, which could show differences on how FDI is affected by corruption based on the industry on which foreign investors operate. This study relied on the perception of corruption as presented by the CPI published by Transparency International. The CPI is broad and does not capture the different forms that corruption has (Habib & Zurawicki, 2002). Nevertheless, corruption has different dimensions (Rodriguez, et al., 2005), which should be taken into account when analysing how corruption affects FDI.

The firm-level analysis also presents limitations. The main limitation of the firm-level section of this study is that it relied on the responses of managers. This means that there is the possibility that the responses provided to the interviews and/or the questionnaire might not be entirely accurate. Also, this study relied on indirect wording to understand how corruption affected the decision-making process of investing in a foreign location as well as subsequent operations. This was made to prevent managers from implicating themselves but it might have also prevented managers from actually answering how often they participated in corrupt acts in the host country. Therefore, the results of this section should not be interpreted as a measurement of how much an MNE actually engaged in corrupt actions, but instead the pressures they faced to do so.

### 7.9.4 Future Research

The limitations of this study provide an opportunity to conduct further studies analysing how corruption affects the attraction of FDI. New studies should analyse how corruption and corruption distance affect FDI at the industry level. This distinction should be made assuming that FDI destined to exploit immobile assets

might not be as affected by corruption than those assets that can be found at another location with less corruption levels. Also, a macroeconomic-level research analysing how corruption distance affects FDI should take into account the different dimensions of corruption in order to understand if such dimensions have different effects based on the levels of corruption of the home country. Further research should also analyse the issues by looking into motives of FDI, as different type of FDI may have different sensitivity of corruption. Research at the firm-level could also be enhanced. Scholars should study how corruption affects the decision-making process of beginning operations abroad as well as following operations in more than one country. This should be made in order to understand if a different institutional setting has a different impact in the same foreign investors.

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## **APPENDIX**

### **Interview Guide**

This research relied on a semi-structured interview to obtain information regarding how corruption affected the decision-making process of allocating investment in a highly corrupt host country, and how corruption affected operations once the decision to invest was made. The interviews although semi structured, had a clear purpose that was based on the existing literature regarding corruption and its effects on FDI.

The following interview guide was utilised to gather information in order to construct a questionnaire to be then handed to a larger sample of respondents regarding how corruption affected their investment process in Guatemala and subsequent operations in the country.

The following is the guide used to conduct the interviews:

### **Introduction**

This phase was used to gather basic information regarding the company, their main business and in which countries it operated. This section also included a description of the research and its implications. Also, due to the high sensitivity of the topic, during the introduction managers were made aware that their identities and responses would remain absolutely confidential.

### **Interview**

After the introduction the interviews started by asking managers how they perceived the issue of corruption in Guatemala in general. After having discussed the current of how corruption affects ‘everyday’ life in the country the topic was stirred towards how corruption affected the decision-making process of the company. While discussing how corruption had affected the allocation of FDI in Guatemala, the conversation was directed towards the effects that the dimensions of corruption had



in the firm. Finally, the conversation was guided to answer how corruption affected present operations of the company in Guatemala.

## Research Questionnaire

My name is Jose Godinez and I am interviewing you as part of my PhD research with the University of Edinburgh, UK. The aim of my research is to better understand how the perception of corruption affects the attraction of foreign direct investment in Guatemala.

Please answer the questions according to your own experience and understanding. Let me ensure you, all information you provide will be treated strictly anonymously and confidentially. Your name or your company's will not be used in any documentation produced as a result of this survey.

Note: Corruption in this research is defined as the abuse of public office for private gain.

### Section 1: Background Information

	Location of the parent company	
a)	When was the parent company established?	
b)	When was the Guatemalan subsidiary established?	
c)	Ownership structure of the Guatemalan subsidiary?	
	a. Joint Venture	
	Percentage of ownership?	
	b. Acquisition of a local company (Brownfield)	
	c. Wholly owned subsidiary (Greenfield)	
	d. Other (Please specify in the blank)	
	e. Don't Know	
d)	Sector on which the Guatemalan subsidiary operates?	
e)	Amount invested in Guatemala in the past 5 years?	
	a. Up to US\$5 million	
	b. Between US\$5 million and up to US\$10 million	
	c. Between US\$10 million and up to US\$20 million	
	d. Between US\$20 million and up to US\$30 million	
	e. More than US\$30 million (Please specify)	
f)	Does the parent company have other subsidiaries in Latin America?	
	a. Yes	

	How Many?	
	Where?	
	b. No	

## Section 2: Perceived corruption in Guatemala

1. To what extent do the following institutions are perceived as corrupt where the company operates? (Five-point scale from 1 = very unlikely to 5 = very likely)

a)	National-level political leaders	
b)	City and other local-level political leaders	
c)	Civil servants at the national level	
d)	Civil servants at the city level	

2. Uncertainty created by corruption. When doing business do you have enough information regarding the following (Five-point scale from 1 = not at all to 5 = yes. Please type 0 if not applicable)

a)	Advance knowledge of how much an unofficial payment for government services will be	
b)	Advance knowledge of whether or not after making an unofficial payment to an officer another payment for the same service should be made to another officer	
c)	Advance knowledge that after making an unofficial payment the service is delivered as agreed	

## Section 3: Perceived Bribery in Guatemala

1. Please indicate how likely companies in Guatemala's business sector in which your company operates are to pay or offer bribes to members of: (Five-point scale from 1 = very unlikely to 5 = very likely)

a)	The political elite (e.g. high-ranking public servants) to achieve corporate gains	
b)	The judiciary system (e.g. congressmen and judges) to achieve corporate gains	
c)	The bureaucracy (e.g. lower-level public servants) to achieve corporate gains	

#### Section 4: Structure of the investment in Guatemala

1. The level of corruption in Guatemala affected (Five-point scale from 1 = not at all to 5 = yes)

a)	The structure of your investment (e.g. joint venture, wholly owned subsidiary)	
	Please Explain	
b)	Your strategy in the country (e.g. less R&D intensive, more market or natural resource seeking, less collaboration with local suppliers)	
	Please Explain	

#### Section 5: Operating in Guatemala

1. Please rate the following questions (Five-point scale from 1 = not at all to 5 = yes)

a)	Is corruption part of the business culture in Guatemala?	
b)	Have you ever seen anyone in your line of business give a bribe to a member of the government elite in Guatemala to 'get things done'?	
c)	Have you ever seen anyone in your line of business give a bribe to a legislator in Guatemala to 'get things done'?	

d)	Have you ever seen anyone in your line of business give a bribe to a bureaucrat in Guatemala to 'get things done'?	
e)	Has a member of the Guatemalan government elite ever asked for a bribe 'to get things done'?	
f)	Has a Guatemalan legislator ever asked for a bribe 'to get things done'?	
g)	Has a Guatemalan bureaucrat ever asked for a bribe 'to get things done'?	
h)	Please indicate how likely is your company to do business with public institutions	
i)	The corruption level in Guatemala prevents your company from obtaining government contracts?	
j)	Corruption among the government elite where the parent company is located has given you knowledge of how to cope with the level of corruption of the government elite in Guatemala?	
k)	Corruption among bureaucrats where the parent company is located has given you knowledge of how to cope with the level of corruption of bureaucrats in Guatemala?	
l)	Corruption among lawmakers where the parent company is located has given you knowledge of how to cope with the level of corruption of the judiciary system in Guatemala?	

End of the questionnaire  
Thank you for your cooperation

## Appendix 1: Macroeconomic Analysis Data tests

### 1.1 Hausman Test for fixed or random effects

	Fixed (b)	Random (B)	Difference (b-B)	Sqrt ((diag (V_b-V_B))
CPI	-12.43085	-6.7703	5.6604	16.303
Human	14.17453	122.836	-108.6619	1486.396
Law	0.2222	0.46145	-0.43921	1.0728
Bureaucracy	0.69912	0.11249	0.58662	1.0165
EcFreedom	-0.22053	-0.1567	-0.06375	0.31702
Education	1.46174	-1.0288	2.49057	133.0215
Inflation	0.75690	0.71076	0.04614	0.56220
Infrastructure	-0.30375	0.3598	0.05012	1.03482
GDP	6.95472	6.65553	0.29937	171.2685
Unemployment	1.685411	0.7223	0.96303	5.23361

b = consistent under Ho and Ha; obtained from xtreg

B = inconsistent under Ha, efficient under Ho; obtained from xtreg

Test: Ho: difference in coefficients not systematic

$$\text{Chi2 (10)} = (b-B)' [ (V_b - V_B)^{-1} ] (b-B) = 0.70$$

$$\text{Prob} > \text{Chi2} = 0.9680$$

## 1.2 Variance Inflation Factor Test

<b>Variable</b>	<b>VIF</b>
CPI	3.92
Human	5.32
Law	5.49
Bureaucracy	8.40
EcFreedom	4.87
Education	2.91
Inflation	1.56
Infrastructure	5.04
GDP	4.69
Unemployment	2.75
Mean VIF	4.495

## Appendix 2: Firm-level Analysis Data tests

### 2.1 Variance Inflation Factor Test Multinomial Logistic Regression of FDI in Guatemala

<b>Variable</b>	<b>VIF</b>
Entry Mode	1.093
Motive	1.033
Subsidiaries	1.099
Mean VIF	1.075

### 2.2 Variance Inflation Factor Test Multinomial Logistic Regression Facing Corruption in Guatemala by Government Sector

<b>Variable</b>	<b>VIF</b>
Government Elite	2.779
Judiciary System	2.565
Bureaucrats	1.355
Mean VIF	2.233

### 2.3 Variance Inflation Factor Test Multinomial Logistic Regression Arbitrariness and Pervasiveness of Corruption in Guatemala

Variable	VIF
Knowledge of price of unofficial payments	1.716
Knowledge if more unofficial payments will be needed	2.596
Knowledge if service will be delivered after an unofficial payment	2.250
Mean VIF	2.1873

### 2.3 Variance Inflation Factor Test Multinomial Logistic Analysis Corruption, Entry Mode and Strategy in Guatemala from 2007-2012

Variable	VIF
Entry Mode	2.850
Strategy	2.848
Mean VIF	2.849

### 2.4 Variance Inflation Factor Test Multinomial logistic regression Corruption and Operations in Guatemala from 2007-2012

Variable	VIF
Is corruption part of the business culture in Guatemala?	1.269
Have you ever seen anyone in your line of business give a bribe to a member of the government elite?	2.833
Have you ever seen anyone in your line of business give a	2.334
Jose Godinez	



bribe to a legislator?	
Have you ever seen anyone in your line of business give a bribe to a bureaucrat?	2.255
Has a member of the government elite asked you for a bribe?	1.615
Has a legislator asked you for a bribe?	
Has a bureaucrat asked you for a bribe?	1.966
How likely is your firm to do business with the government?	4.151
Mean VIF	2.3461